IOPS Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds

IOPS

INTERNATIONAL ORGANISATION
OF PENSION SUPERVISORS

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The International Organisation of Pension Supervisors (IOPS) is an independent international body representing those involved in the supervision of pension funds, including pension supervisors from 77 jurisdictions worldwide - from Albania to Zimbabwe - covering all levels of economic development and bringing together all types of pension and supervisory systems.

The IOPS, formed in July 2004, was instigated by the Organisation for Economic Co-operation and Development (OECD) and the International Network of Pension Regulators and Supervisors (INPRS). It was felt that, concerning supervision, a more formal, independent, body could better serve as a world-wide forum for policy dialogue and the exchange of information, as well as a standard-setting body, promoting good practices in pension supervision.

Foreword

Environmental, Social and Governance (ESG) factors are key and timely issues for the investment and risk management of pension funds, whose consideration is relatively new in the landscape of regulatory frameworks of pension funds worldwide. They are also dynamically evolving and have different impacts and risks depending on the country.

It was therefore critical for the International Organisation of Pension Supervisors (IOPS), whose mandate is to act as the standard-setting body on pension supervisory issues and on regulatory issues related to pension supervision, to bring the views and experience of their members together on how ESG factors should be considered and integrated in the supervision of investment and risk management of pension funds.

Based on gathered experiences, these guidelines are the outcome of numerous discussions held at several IOPS meetings over the last two years. They are voluntary in nature and are intended to guide supervisors and other entities involved in supervision of pension fund risk management and investment. They should be read in conjunction with the IOPS Principles of Private Pension Supervision and IOPS Good Practices on Pension Funds Investment Governance.

We would like to thank IOPS Members for their active involvement and great contributions to the elaboration of these guidelines. We also want to thank external stakeholders for providing their valuable comments during the public consultation held in January-March 2019.

We hope that these IOPS supervisory guidelines will encourage supervisory authorities to voluntarily adopt and implement them.

Dr Olga Fuentes, Acting IOPS President

Brendan Kennedy

Brendan Kennedy, Chair of IOPS Technical Committee

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Table of Contents

Background note

The investment and risk management of pension funds constitute two of the most important elements of governance. Some of the issues related to investment and risk management process of pension funds were already addressed in the OECD Core Principles of Private Pension Regulation (2016)[1], the OECD/IOPS Good Practices for Pension Funds' Risk Management Systems (2011), and the OECD/IOPS Good Practices on Pension Funds' Use of Alternative Instruments and Derivatives (2011). The OECD Core Principles of Private Pension Regulation deal with investment and risk management process (Core Principle 4) in general[2], whereas the above OECD/IOPS Practices focus on the risk management and investment process of pension funds in the context of alternative instruments and derivatives.

However, recent developments show that, in their investment analysis process, pension funds, like other institutional investors, take more and more often environmental, social and governance (ESG) risks and opportunities into account.[3] In the context of pension funds (schemes), such activity may be instigated by fund members, investment managers or policy makers. Pension fund members might be concerned about various issues in relation to companies the funds invest in, such as for example, environmental factors, fair treatment of the labour force or production of controversial weapons. Members

[1] http://www.oecd.org/finance/principles-private-pension-regulation.htm

[2] The Core Principle 4 provides implementing guidelines on such key features as: retirement income objective and prudential principles; prudent person standards – fiduciary standards and safeguards; investment policy – objectives, process and review; portfolio limits and other quantitative requirements; valuation of pension assets; performance assessment and monitoring procedure.

[3] See for example OECD (2017) *Investment governance and the integration of environmental, social and governance factors*, https://www.oecd.org/finance/Investment-Governance-Integration-ESG-Factors.pdf

may therefore exert pressure on a governing body to alter a pension fund's asset allocation. Managers of pension funds may be worried about the potential effects of the implementation of policy measures (new regulations) that may have adverse impact on the value of their investment portfolio. The drive for such change can also be prompted by existing regulations and the rapidly evolving initiatives of international organisations. These relate to developments such as the Paris Agreement – a global climate treaty negotiated at the COP21 meeting in Paris in December 2015, the work of the Principles for Responsible Investment (PRI)[4] and the Task Force on Climate-related Financial Disclosures[5], new IORP II Directive, or the work of G20 Sustainable Finance Study Group. In December 2016, the Sustainable Insurance Forum (SIF) was established to strengthen insurance supervisors' and regulators' understanding of and responses to sustainability challenges and opportunities for the business of insurance, focusing on environmental dimensions including climate change. Most recently, the Central Banks and Supervisors Network for Greening the Financial System was established to better understand and manage the financial risks and opportunity of climate change.[6] The importance of responsible business conduct has been raised by the OECD.[7] In addition, the European Commission has been working on issues related to ESG factors. In May 2018, the Commission presented a package of measures as a follow-up to its action plan on financing sustainable growth. The package includes three proposals aimed at establishing a unified EU classification system of sustainable economic activities, i.e. an EU taxonomy;

[4] See the comprehensive report on the state of fiduciary duties: *Century Fiduciary Duty in the 21 Century*, UN Global Compact, UNEP Finance Initiative, PRI Principles for Responsible Investment, UNEP Inquiry: Design of a Sustainable Financial System, 2015, http://www.unepfi.org/fileadmin/documents/fiduciary_duty_-21st_century.pdf

[5] https://www.fsb-tcfd.org/

[6] In December 2017, https://www.banque-france.fr/en/communique-de-presse/joint-statement-founding-members-central-banks-and-supervisors-network-greening-financial-system-one

[7] See OECD (2014) *OECD Guidelines for Multinational Enterprises: Responsible Business Conduct Matters*, http://mneguidelines.oecd.org/MNEguidelines_RBCmatters.pdf

improving disclosure requirements on how institutional investors integrate ESG factors in their risk processes; and creating a new category of benchmarks that will help investors compare the carbon footprint of their investments.[8] The Commission established the EU High-Level Group on Sustainable Finance (HLEG) that published its report in January 2018. Amongst its various recommendations, the HLEG underlines that investor duties should be clarified by "extending the time horizons of investment and bringing greater focus on ESG factors into investment decisions", as well as "upgrading disclosures to make sustainability opportunities and risks transparent" to investors.[9]

The Paris Agreement commits signatories to follow through with their pledges to help contain global warming to within 2°C of pre-industrial levels by introducing legislation to mitigate climate change. From the perspective of pension funds, these recent developments imply that a possible depreciation of certain assets and appreciation of others may occur in the future due to changes in regulations and/or asset allocation by institutional investors.

The industry-led Task Force on Climate-related Financial Disclosures, established by the Financial Stability Board, works to help identify the information needed by investors, lenders and insurance underwriters to appropriately assess and price climate-related risks and opportunities. The Task Force developed voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders, and insurance underwriters in understanding material risks.[10] The Task Force expects that its recommendations will be followed not

[8] https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en

[9] HLEG (2018). *Financing a Sustainable European Economy*, Final Report 2018 by the High-Level Expert Group on Sustainable Finance (HLEG), https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf. In the context of financial system, the HLEG proposes that assets managers including pension funds, and investment consultants take into account the sustainability preference of their clients. The report recommends also that credit rating agencies disclose how they consider ESG factors, and that listing authorities promote disclosure of ESG information.

[10] Recommendations of the Task Force on Climate-related Financial Disclosures, December 2016, https://www.fsb-tcfd.org/wp-content/uploads/2016/12/16_1221_TCFD_Report_Letter.pdf

only by all financial and non-financial organisations with public debt or equity but also by organisations across all sectors, including asset managers and asset owners such as public and private-sector pension plans and insurance companies. The rationale is that "climate-related financial information should be provided to asset managers' clients and asset owners' beneficiaries so that they may better understand the performance of their assets, consider the risks of their investments, and make more informed investment choices".

Following the implementation of the IORP II Directive by 13 January 2019, pension funds in the European Union classified as Institutions for Occupational Retirement Provision (IORP) are required to conduct risk management assessments "which should, where relevant, include, inter alia, risks related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets')".[11] Moreover, the IORP II Directive requires that IORPs explicitly disclose where ESG factors are considered in investment decisions and how they form part of their risk management system.[12] In July 2019 the European Insurance and Occupational Pensions Authority (EIOPA) published two opinions relating to the issues of governance and risk assessment of ESG factors by IORPs.[13]

In a number of other jurisdictions, ESG issues are already also addressed in legislation. For instance, in Brazil, Resolution 3792 requires investors to take social and environmental factors into

[11] IORP II Directive, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016L2341, Preamble, point 57.

[12] "The relevance and materiality of …[ESG]… factors to a scheme's investments and how such factors are taken into account should be part of the information provided by an IORP under this Directive. This does not preclude an IORP from satisfying the requirement by stating in such information that …[ESG]…factors are not considered in its investment policy or that the costs of a system to monitor the relevance and materiality of such factors and how they are taken into account are disproportionate to the size, nature, scale and complexity of its activities." (IORP II Directive, Preamble, point 57).

[13] See EIOPA (2019): *Opinion on the use of governance and risk assessment documents in the supervision of IORPs (EIOPA-BoS-19-245); Opinion on the supervision of the management of environmental, social and governance risks faced by IOPRs (EIOPA-BoS-19-248)*, https://eiopa.europa.eu/publications/eiopa-opinions

account when making investment decisions. In Chile, pension funds are asked but not evaluated on whether they consider ESG risks. Colombia's supervisory authority is developing a guideline on the due diligence process in investment by pension funds that will include the analysis of ESG factors. In Denmark, the guidelines for financial reporting covering pension funds and insurance companies (BEK no 937 af 27/07/2015) state that companies that have their securities admitted to trading on a regular market in an EU/EEA country as well as companies that run life insurance business must supplement their management report with a statement of social responsibility. The statement describes how the company voluntarily integrates in its business strategy and activities, inter alia, human rights, social conditions, environmental and climatic conditions. In cases where the company has no such policy, this fact must be disclosed. In Mexico, the recently updated (November 2018) General Provisions on Financial Matters establish that pension funds may consider ESG factors in their risk management policy and investment strategy.[14] If the administrator of a pension fund in Mexico decides through its committees to integrate ESG factors in its investments and risk management, it should briefly explain in the information handout the purpose of these investments and how ESG factors are incorporated in both investment and risk management. In South Africa, the Financial Sector Conduct Authority (FSCA) issued for consultation a draft directive prescribing the sustainability reporting and disclosure requirements for pension funds. The directive will require that boards of funds consider environmental, social and governance factors before investing in an asset.

[14] *Disposiciones de carácter general en materia financiera de los Sistemas de Ahorro para el Retiro*, http://www.dof.gob.mx/nota_detalle.php?codigo=5544140&fecha=16/11/2018

Introduction to the IOPS Guidelines

Regulatory frameworks in most of the jurisdictions tend to focus (via risk-based controls and prudential standards) on the governance of pension funds, including risk management systems, but still do not explicitly refer to Environmental, Social and Governance (ESG) factors.[15] This document contains a set of guidelines on the integration of ESG factors in the area of supervision of pension fund investment and risk management. The document also proposes an enhanced disclosure of ESG factors by pension funds. These Guidelines should be read in conjunction with the International Organisation of Pension Supervisors' (IOPS) Principles of Private Pension Supervision[16] and IOPS Good Practices on Pension Funds' Investment Governance.[17] The IOPS Guidelines are voluntary in nature and are intended to guide regulators, supervisors, and other entities involved in supervision of pension risk management and investment. **Therefore, the word "should" is to be interpreted as an encouragement to supervisory authorities to voluntarily adopt and implement them.** When elaborating these Guidelines, other existing international standards were considered to avoid duplication.

The subject matter is relatively new and dynamically evolving. Therefore, it was critical for the IOPS to bring the views and experience of Members together on how ESG factors should be

[15] OECD (2017), *Investment governance and the integration…,* op. cit. However, with regard to EU and EEA Member States this situation has changed with the transposition of the IORP II Directive into national law by 13 January 2019.

[16] http://www.iopsweb.org/principlesguidelines/IOPS-principles-private-pension-supervision.pdf

[17] OECD/IOPS Good Practices on Pension Funds' Use of Alternative Instruments and Derivatives (2011), OECD/IOPS Good Practices for Pension Funds' Risk Management Systems (2011), IOPS Good Practices in the Risk Management of Alternative Investments by Pension Funds (2010).

considered and integrated in the supervision of investment and risk management of pension funds. Based on gathered experiences, the aim of this document is to help supervisors respond to possible further regulatory developments in this area. ESG factors represent both potential risks and opportunities to pension funds. It is important to underline that these Guidelines do not intend to induce pension funds into ESG investments but to require them to integrate in their investment and risk management process ESG factors that may have financial consequences.

The implementation of these Guidelines may vary from jurisdiction to jurisdiction depending on the structure of the private pension system. **While the principle of proportionality[18] is explicitly mentioned in guidelines 5 and 10, it should also be taken into account in the implementation of other guidelines.** As a result, the Guidelines are non-binding and they are to provide guidance and serve as a reference point for supervisory authorities. As such, supervisory authorities may apply them if they so wish in accordance with their regulatory and supervisory framework and the structure of their private pension system. Since the Guidelines are largely principle-based, they should be flexible in their application.

Like the previously developed IOPS principles and guidelines, these Guidelines are intended to apply to funded private pension funds or plans where assets are being invested in capital markets during accumulation and decumulation phases, regardless of whether these pension arrangements are voluntary or mandatory in nature and regardless of whether they serve as the primary or supplementary source of retirement income.

Definitions

These Guidelines define ESG factors as “indicators used to analyse a (investee) company’s prospects” (OECD, 2016)[19] which are based on measures of its performance on environmental, social, and corporate

[18] I.e. the size and internal organisation of pension funds, as well as the size, nature, scale and complexity of the activities of pension funds and complexity of governing structure.

[19] OECD (2017), *Investment governance and the integration…*, op. cit., page 7.

governance criteria.[20] The investments by pension funds are long-term and are therefore exposed to longer-term risks. ESG risks and opportunities include those related to environmental issues (including climate change), social issues, unsustainable business or unsound corporate governance practices. According to the definition by the Principles for Responsible Investment, environmental issues relate to "the quality and functioning of the natural environment and natural systems"; social issues relate to "the rights, well-being and interest of people and communities"; and governance issues relate to "the governance of companies and other investee entities."[21] Most ESG risks and opportunities have a long-term nature and therefore are obviously relevant for long-term investors such as pension funds. In particular, complex and difficult-to-predict effects of climate change and related regulatory responses may have a long-term character and may not be immediately and fully reflected in financial markets.

Governing body is defined as "the person(s) ultimately responsible for managing the pension fund with the overriding objective of providing a secure source of retirement income. In cases where operational and oversight responsibilities are split between different committees within an entity, the governing body is the executive board of the entity. Where the pension fund is not a legal entity, but managed directly by a financial institution, that institution's board of directors is also the governing body of the pension fund."[22] The term covers also cases where the governing body is comprised of trustees.

For the use of these Guidelines, *financial factors* are understood as those which may influence investment decisions because of financial reasons. For example, an institutional investor may decide about disinvesting from a certain company due to concerns about the company's future legal litigations or loss in its shares' value including 'stranded assets'. *Non-financial factors* are those that may also influence investment decisions but such decisions are not motivated by financial reasons. For example, an institutional investor may decide

[20] I.e., contrary to the original OECD (2017) definition, these Guidelines assume that ESG factors do not include ethical criteria.

[21] Principles for Responsible Investment (2017). *PRI Reporting Framework. Main definitions 2018*, https://www.unpri.org/download?ac=1453

[22] OECD (2005), *Private Pensions Classification and Glossary*, page 44, http://www.oecd.org/daf/fin/private-pensions/38356329.pdf

to disinvest from a company because of ethical considerations, independently from an assessment of the likelihood that the company loses value because of its unethical behaviour.[23] Obviously, non-financial decisions still may have financial implications for the pension fund.

ESG-related factors may have a direct, and potentially substantial, financial impact on the savings and well-being of pension fund members, particularly in the longer term. While they have both financial and non-financial components and in this respect are thus "hybrid" factors, **for the purpose of this document ESG factors will be considered as a subset of financial factors**.

Examples of ESG risks

Environmental risks may represent *physical risks* that stem from the direct impact of natural catastrophes such as earthquakes or floods, climate change, greenhouse gas emissions, renewable energy, resource depletion, including water waste and pollution and deforestation on the physical environment and individuals. These may, for example, affect resource availability, disrupt or damage supply chains, or damage property and assets as a result of severe weather (droughts, floods, storms, change of sea and water levels, deforestation, waste and pollution, etc.). They may also relate to *transition risks* that stem from the much wider set of changes in policy, law, markets, technology, investor sentiment and prices due to the transition towards a low-carbon economy.[24] Transition risks may

[23] Non-financial factors are "factors which might influence investment decisions that are motivated by other (non-financial) concerns, such as improving members' quality of life or showing disapproval of certain industries." (Definition by the UK Pensions Regulator (2014), *Fiduciary Duties of Investment Intermediaries Report Guidance*, http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/). In this vein, investment decisions influenced by these factors are not motivated by financial reasons, even though effects of such decisions can be quantified in financial terms (e.g. withdrawing investments from a particular industry due to ethical concerns).

[24] Some supervisors have already acknowledged that some climate risks can have financial consequences (see speech *Australia's new horizon: Climate change challenges and prudential risk* by Geoff Summerhayes, Executive Board Member delivered at the Insurance Council of Australia Annual Forum, Sydney, 17 February 2017, https://www.apra.gov.au/media-

therefore materialise in the repricing of carbon-intensive assets and reallocation of capital, adversely affecting asset owners and managers, including pension funds. A third group of risks related to climate change are *liability risks* that may affect insurers, governments and government agencies[25] due to legal or moral responsibility to cover financial losses caused by climate-change-induced events. Environmental issues may also provide opportunities such as access to new markets and new technologies.[26]

Social risks relate to working conditions, including slavery and child labour; local communities, including indigenous communities; conflicts; health and safety issues (e.g. mining accidents); employee relations and diversity, discrimination in respect of employment and occupation, violations to freedom of association and the effective recognition of the right to collective bargaining, industrial actions (strikes), etc.[27]

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centre/speeches/australias-new-horizon-climate-change-challenges-and-prudential-risk; Bank of England, *The impact of climate change on the UK insurance sector. A Climate Change Adaptation Report* by the Prudential Regulation Authority, September 2018, https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/impact-of-climate-change-on-the-uk-insurance-sector.pdf?la=en&hash=EF9FE0FF9AEC940A2BA722324902FFBA49A5A29A

[25] Bank of England, *The impact of climate `change…*, op. cit.

[26] More examples can be found in TCFD (2017). *Implementing the Recommendations of the Task Force on Climate-Related Financial Disclosures*, Task Force on Climate-related Financial Disclosures, https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Annex-062817.pdf

[27] See Principles for Responsible Investment, https://www.unpri.org/about/what-is-responsible-investment and ILO Fundamental Principles and Rights at Work, https://www.ilo.org/declaration/lang--en/index.htm. Social factors can also be grouped into social capital (relating to the perceived role of business in society or the expectation that a business will contribute to society in return for a social license to operate) and human capital (relating to the management of a company's human resources as key assets to delivering long-term value), see Sustainability Accounting Standards Board (SASB),

Governance risks relate to executive pay, the respect of the rule of law, bribery and corruption, political lobbying and donations, board diversity and structure, tax strategy, cybersecurity, accounting frauds, etc.[28] Typical issues relating to listed equity companies include: "board structure, size, diversity, skills and independence, executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls and risk management, and, in general, issues dealing with the relationship between a company's management, its board, its shareholders and its other stakeholders."[29] In addition, governance issues regarding issuers can relate to anti-money laundering (AML) and combating the financing of terrorism (CFT) concerns. In the case of unlisted companies, governance issues "also include matters of fund governance, such as the powers of Advisory Committees, valuation issues, fee structures, etc."[30] Governance issues may also provide opportunities for improving fund's own governance.

These Guidelines were submitted for discussion by IOPS Members and subsequently for public consultation with other stakeholders, including international organisations.

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https://www.sasb.org/wp-content/uploads/2017/02/SASB-Conceptual-Framework.pdf.

[28] See Principles for Responsible Investment, https://www.unpri.org/about/what-is-responsible-investment

[29] Principles for Responsible Investment (2017), *PRI Reporting Framework…*, op. cit.

[30] Principles for Responsible Investment (2017), *PRI Reporting Framework…*, op. cit.

I. ESG factors in the investment and risk management process

Guideline 1

Supervisory authorities should require that a pension fund governing body consider environmental, social and governance (ESG) factors, along with all other substantial financial factors, that may contribute to achieving the long-term retirement objectives of pension fund members and their beneficiaries. In particular, such wider considerations should be taken into account in the pension fund's investment and risk management process.

The OECD Core Principles of Private Pension Regulation state that the duty of pension providers is to manage the assets in the best interests of their members and beneficiaries. Objectives of investment undertaken on behalf of pension fund members have been traditionally defined by governing bodies and asset managers in financial terms: pension funds are typically expected to maximise the risk-adjusted returns/retirement benefits or to preserve the real value of pension assets/retirement benefits. They do so by focusing on financial risks. ESG factors are often considered to be non-financial[31] factors or be part of non-financial performance indicators.[32] However, even so, ESG factors may have a direct, and potentially substantial, financial impact on the savings and well-being of pension fund members, particularly in the longer term. Therefore, for the purpose of this document ESG factors will be considered as financial ones.[33] Indeed, ESG factors may materially impact the long-term risk and return of

[31] OECD (2017), *Investment governance and the integration…,* op. cit., page 21.

[32] http://lexicon.ft.com/Term?term=ESG

[33] See OECD (2017), *Investment governance and the integration…*, op. cit.

investments, a company's valuation and reputational risk, as well as its operational efficiency (governance). As a result, a prudent investor should integrate these factors into their investment and risk management process.[34] When considering ESG strategies, governing bodies of pension funds should also take into account costs related to implementation of such investment strategies.

Guideline 2

Supervisory authorities should clarify to a pension fund governing body or the asset managers, possibly through regulations, rules or guidelines, that the explicit integration of ESG factors into pension fund investment and risk management process is in line with their fiduciary duties.

Governing bodies of pension funds in some jurisdictions have already started integrating ESG factors in their investment and risk management process.[35] This process will continue in the EU and EEA with the transposition of the European IORP II Directive. However, in some jurisdictions, particularly in common law jurisdictions where trustees constitute the pension governing bodies, a lack of guidance from pension supervisory authorities on integration of ESG factors may create legal uncertainty as to how such integration fits with governing bodies' legal, regulatory and other obligations.[36]

[34] For example, due diligence can be carried out in line with the OECD Guidelines for Multinational Enterprises and on the basis of recommendations developed in OECD (2017) *Responsible business conduct for institutional investors*, op. cit., which offer guidance to asset owners and investment managers on how to identify and respond to environmental and social risk in their portfolios. The recommended due diligence process suggests to investors that they identify, prevent and mitigate the real and potential adverse environmental and social impacts in their portfolios and take due account of the size and nature of the investor, their investment strategy, their types of products, and the significance of any real and potential adverse environmental and social impacts.

[35] Such as Australia, Canada, France, the UK.

[36] The European Commission-appointed High Level Expert Group (HLEG) on sustainable finance has recommended it be clarified that managing ESG risks is an integral part of fiduciary duty. According to HLEG, a single set

Integration of ESG factors may provide opportunities related to clean technologies, reduce the risk of financial losses due to physical damages caused by climate changes or environmental and regulatory changes[37], help address social needs (such as dialogue with workers and stakeholders) and improve governance (for example, by avoiding companies with little engagement with minority stakeholders, opaque standards or conflicts of interests). Improved reputation and governance[38] may translate into better financial performance. Any guidance from supervisory authorities, especially in common law jurisdictions, should aim to eliminate uncertainty on integration of ESG factors in decision-making by pension governing bodies. Despite the potential opportunities, the risks of ESG investments also have to be adequately considered.

of principles on fiduciary duty and the related concepts of loyalty and prudence should be established in the European Union. The asset managers should, in line of their fiduciary duty, implement the identification, disclosure and effective management of potential physical and transition risks posed by climate change (HLEG (2017) Interim Report, July 2017, http://www.eurosif.org/wp-content/uploads/2017/07/HLEG-on-Sustainable-Finance-IR-For-website-publication.pdf). See also HLEG (2018), *Final Report*, https://ec.europa.eu/info/publications/180131-sustainable-finance-report_en).

[37] Therefore reducing or avoiding the risk of stranded assets that may occur due to changes in demand and/or regulatory changes.

[38] These effects might also be pursued by applying active ownership practices, i.e. the use of the rights and position of ownership to influence the activities or behaviour of investee companies. Active ownership practices do not necessarily have to deal with ESG issues only.

Guideline 3

When pension funds offer members investment options that partly take into account non-financial factors, such options may possibly result in sacrificing some return as compared to options that are defined on purely financial grounds. In this case, supervisory authorities should require that the potential and actual members be properly informed so that they can make an informed choice in selecting their investment options.

Pension fund members must be made aware of any significant sacrifice of risk-adjusted returns that can occur due to following investment strategies (e.g. ethical investment) that are not entirely based on financial factors.

Guideline 4

Supervisory authorities should require that when offering investment arrangements, the pension fund's investment policy should consider ESG factors with no prejudice for the objective of obtaining an appropriate risk-return profile on purely financial grounds.

Investment strategies, including the default investment strategy, should be defined and explained in a pension fund's investment policy statement. Such policies should establish clearly the financial and other objectives of the pension fund and the manner in which these objectives will be achieved, being consistent with the retirement objective of the pension fund. The investment policy should outline how a pension fund intends to consider environmental, social and governance factors while pursuing its risk-return objective.

II. Integration of ESG factors in the investment and risk management process

Guideline 5

Supervisory authorities should require that a governing body and the asset managers involved in the development and implementation of a pension funds' investment policy integrate ESG factors, along with all substantial financial factors, into their investment strategies (analysis and decision-making process). Supervisory authorities should avoid being overly prescriptive on how governing bodies should deal with ESG factors but rather emphasize the need to document the ways a particular governing body is treating such factors. Supervisory authorities should also request that in case these factors are not integrated in investment and risk management process, a governing body and the asset managers provide explanations. Integration of ESG factors may be subject to the principle of proportionality, i.e. the scale of the pension funds and complexity of its governing structure.

When pursuing financial returns, pension fund governing bodies and asset managers should consider all substantial factors that can financially impact a pension fund. However, prudential regulations or rules should not make a separate case for ESG factors or any other emerging risks (such as for example digital innovations) but encourage pension funds' governing bodies or asset managers to fully integrate ESG factors into their risk management and investment management process. Governing bodies should therefore integrate risk factors that are relevant for a pension fund and its members and beneficiaries, and have them implemented in the overall investment process. The governing body should be able to demonstrate to supervisors how they can take into account these factors. The process of integration of ESG factors should recognize a pension fund's specific circumstances and portfolio asset allocations as well as the availability of investment options in the market. The granularity level of incorporation of ESG factors and other substantial financial factors in investment and risk management process may be subject to proportionality, as for example, smaller pension funds that outsource investment management activities may find it at the beginning more difficult and costly to incorporate these factors.

Guideline 6

Supervisory authorities may wish to issue regulations, rules or guidelines on how a pension fund's governing body or the asset managers when setting up their investment policy, should analyse ESG factors.

While not being overly prescriptive, supervisory authorities may wish to issue regulations, rules or guidelines on how governing bodies should accommodate or integrate in their investment policy factors that are financially material to the performance of an investment, including ESG factors, as well as any other issues that are financially significant.[39] Supervisory authorities should ensure that a pension fund governing body and the asset managers analyse these factors in terms of implications for pension funds members and beneficiaries over a time horizon appropriate to the scheme's liabilities and obligations to members and beneficiaries. In less sophisticated markets or those that have not yet developed sufficient depth to provide reliable and actionable ESG information, data on ESG factors may be limited. In that sense, pursuing investments only in companies that adhere to ESG principles might be restrictive.

The investment policy statement should set up a pension fund's risk appetite in line with the members' preferences, where relevant, and specific attributes of the fund. Therefore, such an approach should be broader than incorporating the ESG factors only. In particular, in order to be able to undertake any investment strategy that incorporates ESG or other emerging risks, governing bodies and the asset managers should, where it is proportionate in terms of the resources used and the insights gained, make sure they are able to not only identify but also to measure and monitor these risks. The investment policy statement may also specify the pension fund's voting policy.

[39] For example financial innovation issues such as blockchain technology or robo-advice.

III. Disclosure of ESG factors in the investment and risk management process

Guideline 7

Supervisory authorities should require that a governing body or the asset managers involved in the development and implementation of the pension fund's investment policy will report to supervisory authorities how they integrate ESG factors in their investment and risk management process.

Supervisory authorities should expect that pension funds will report on their awareness of ESG-related risks, estimated exposure to these risks, and methods they use to incorporate ESG factors in their investment and risk management process. In particular, pension funds may wish to present their plans for the transition towards a low-carbon economy and the ways they manage risks related to changes to market sentiment, new financial or environmental regulations or the emergence of new technologies.[40] A possible form of reporting of the integration of ESG factors in the investment and risk management process can be the provision of the investment policy and the risk management rules to the supervisory authority as well as informing other stakeholders. Based upon the information received from supervised entities, supervisory authorities may consider developing a heat-map of potential ESG-related risks, including climate change, in its pension industry and/or identify entities with the best practices.

[40] *The weight of money: a business case for climate risk resilience* by Geoff Summerhayes, Executive Board Member delivered at the Centre for Policy Development, Sydney on Wednesday, 29 November 2017, Sydney, https://www.apra.gov.au/media-centre/speeches/weight-money-business-case-climate-risk-resilience

Guideline 8

Supervisory authorities should issue regulations, rules or guidelines on how a pension fund's governing body or the asset managers, when setting up their investment policy, should report to its members and stakeholders on substantial financial factors, including ESG factors.

When issuing regulations, rules or guidelines on reporting ESG factors, along with other substantial financial factors, supervisory authorities should consider existing international work on this matter and industry standards, with a proper account given to the stage of development and other specificities of local pension and financial markets.

Guideline 9

Supervisory authorities should require that, in their investment policy statement, a governing body or the asset managers of a pension fund disclose to members and stakeholders information about the pension fund's investment policies in relation to long-term sustainability, including ESG factors, stewardship and non-financial factors. Where appropriate, pension funds should also regularly provide reports on their engagement with investees as well as request companies in which they invest to disclose their ESG-related policies.

Governing bodies of a pension fund or agents who exercise the ownership rights of a pension fund, should exercise ownership rights and disclose the information on their engagement with the companies the pension fund invests in, including voting and engagement rights, in order to safeguard sustainable returns in the long term. Investment, voting and engagement activities should be reported to pension fund members and stakeholders on a regular basis.[41] Information on other actions such as application of exclusionary policies, positive screening and participation in initiatives with sustainability objectives may also be disclosed. Financial disclosures on ESG matters[42] (e.g. carbon footprints) should help investors appropriately assess and price ESG risks and opportunities, therefore creating the right incentives for investors, as well as help pension fund governing bodies, members and their beneficiaries understand the risks of pension fund investment and make more informed investment decisions. Pension funds should be informed about the ESG-related policies of their investees (companies) and relevant disclosures.

[41] See for example NEST, Statement of investment policy, point 8.7, https://www.nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/statement-of-investment-principles,PDF.pdf

[42] With regard to climate-related information, the Task Force on Climate-related Financial Disclosures recommends institutional investors disclose information about: 1) the organisation's governance around climate-related risks and opportunities; 2) the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning; 3) how the organisation identifies, assesses, and manages climate-related risks; 4) the metrics and targets used to assess and manage relevant climate-related risks and opportunities. (*Recommendations of the Task Force…*, op. cit., p. 16). Sustainability Accounting Standards Board (SASB) provides industry-specific sustainability accounting disclosure standards, including measurement metrics (http://materiality.sasb.org/).

IV. Scenario testing of investment strategies

Guideline 10

Supervisory authorities should encourage a governing body or the asset managers of a pension fund to develop appropriate scenario testing of its investment strategy. Such tests should consider all substantial financial factors, including ESG factors. The scope and complexity of stress tests should be subject to the principle of proportionality.

Governing bodies of a pension fund or asset managers should be encouraged to determine appropriate scenarios tests for each investment strategy. Scenario-based thinking about risks should support risk management. Such scenarios should cover a range of factors, including ESG factors[43] (environmental risk scenarios in particular) that can cause extraordinary losses or make the control of risk in the investment strategy difficult. Governing bodies of a pension fund or the asset managers should use these scenarios to undertake scenario testing in order to confirm that the particular investment strategy is appropriate.[44] The principle of proportionality should apply.

[43] The Task Force on Climate-related Financial Disclosures recommends that financial investors describe the potential impact of different scenarios, including a 2°C scenario, on the organisation's businesses, strategy, and financial planning (Recommendations of the Task Force…, op. cit., p. 16).

[44] Cf. requirements for stress testing stipulated in Prudential Standard SPS 530, Investment Governance, APRA, July 2013, https://www.apra.gov.au/sites/default/files/prudential-practice-guide-spg-530-investment-governance.pdf

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