Institute and Faculty of Actuaries

Public Consultation on Long-Term and Sustainable Investment

IFoA response to the European Commission

24 March 2016

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

European Commission
Directorate-General for Justice and Consumers
Company Law Unit

24 March 2016

Dear Sirs

EU Consultation on long-term and sustainable investment

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the EU Commission's public consultation on long-term and sustainable investment. This response has been led by members of our Resource and Environment Board and Resource and Environment Research Committee who have expertise in the impact of environmental issues such as climate change on investment. Our knowledge of investment practices primarily relates to UK asset owners and their investment managers.

General comment

We would welcome increased emphasis on the long-term and ESG factors in investment decisions as we believe this is likely to deliver better long-term outcomes for society, for example by encouraging the transition to a sustainable, low carbon economy. Many investors currently adopt a relatively short-term perspective, so there is a need for policy and regulatory initiatives which encourage the development of long term thinking and thus behaviour. We would like to see more extensive and more consistent corporate disclosures on ESG matters; greater clarity regarding investors' fiduciary duties; and measures which encourage active asset ownership, thereby helping to reconnect investors with the social and economic consequences of their activities.

Answers to specific questions posed in the consultation

We have omitted questions where we do not have any specific comment.

For the avoidance of doubt, we understand that by "institutional investors" you mean asset owners (e.g. pension fund trustees and insurance companies) but not asset (investment) managers, and that by "investors" you mean both asset owners and asset managers. This is how we have used these terms in our response, but we note the potential for confusion. The distinction between asset owners and asset managers is important, given the very different roles they have (even though some organisations, such as certain insurance companies, combine the two functions).

1.a. Do ESG factors play a role in the investment decisions of investors? If not, why? If yes, please specify which considerations are reflecting in your investment policy and mandates? In what form is this commitment expressed?

ESG factors play a varying role in investment decisions and in some cases they are not taken into account. For example, in actively managed funds using a bottom-up approach to create their portfolio, this would be considered as part of corporate governance in a systematic way. On the other hand, consideration of ESG is a lot less likely to be considered for quantitative investment strategies.

Overall, in recent years there has been a greater focus on what might be termed long term value creation (and the role of ESG factors therein) combined with low probability but high impact (ESG) risks.

1.b. What is the main rationale for institutional investors and asset managers to take ESG risks and opportunities into account in their investment decisions? Please indicate all the relevant issues (multiple choice):

Risk management	Yes
Managing asset value risk in the short-term, including preservation of investment value, better investment performance	Yes
Managing asset value risk in the medium-to long-term, mitigation of exposure to long-term and systemic risks	Yes
Management of liability risks	No
Alignment of investment policies with the long-term interests of beneficiaries of the institutional investor	Yes
Pressure from clients on whose behalf the institutional investor invests funds	Yes
Seeking a positive social or environmental impact of investments	Yes
Ethical considerations	Yes
Legal or regulatory constraints, please specify	No
Other, please specify Mitigating the risk to sponsors' ability to fund pension schemes arising from systemic environmental risks to their business model	Yes

2.a. Which ESG risks do you perceive as material to investors?

Many ESG risks are potentially material to investors. Whether they are actually material is a matter of judgement which depends on the specifics of the investment concerned and the timeframe considered. We therefore do not think it is generally possible to classify individual ESG risks as material or otherwise. Moreover, the distinction between ESG and other risks is not clear-cut and we suggest that it can be problematic to separate them. The term ESG integration, frequently used in responsible investment, illustrates that point. Many risks are managed in investment management, and ESG integration simply provides a richer, more sustainable, investment process. Despite this, carbon asset risk is now considered to be a material (and systemic) risk by an increasing number of institutional investors (their vulnerability to the impact of policy measures to reduce GHG emissions).

2.b. What are the main sources of reliable and relevant information for investors on material medium- to long-term risks and opportunities, particularly on ESG issues?

- Corporate reporting
- ESG data providers
- Some regular investment research
- The work of NGOs and academics, e.g. Carbon Tracker, CDP, Cambridge Institute of Sustainability Leadership, Smith School of Enterprise and Environment

2.c. Is it difficult for investors to access such information? If so, please specify:

Failure to access ESG information often lies as much in the lack of demand from investors as in access barriers.

Furthermore, when investors do access carbon/GHG emissions reporting data, it is currently incomplete and inconsistent. We hope that the Michael Bloomberg-led Task Force on Climate-related

Financial Disclosures sponsored by the Financial Stability Board will help to remedy much of this problem.

2e. What factors may prevent or discourage companies from disclosing such data?

Commercial considerations, cost and legal risk are important factors, particularly when seeking to provide forward-looking statements about a naturally uncertain future. Backward looking data relating to ESG factors may be subject to measurement difficulties, including lack of generally accepted definitions and methodologies in some areas.

The threats to the sustainability of the business models of fossil fuel and energy-intensive companies, accentuated by the Paris Agreement of COP21, generate a natural reluctance for some companies to readily provide the information investors seek.

2.f. What is the main rationale for companies to publish such information? Please indicate all the relevant issues. (multiple choice)

relevance of ESG issues to company performance	Yes
attracting financing for specific projects, for example green bonds	Yes
legal or regulatory constraints	Yes
demand from investors	Yes
pressure from stakeholders	Yes
Other	n/a

2.g. Is there sufficient accountability for the disclosure by companies of such information?

There is not sufficient accountability and there is poor practice, particularly outside the main markets. Pressure from investors and other stakeholders will continue to encourage greater future accountability, but this needs to be supplemented by measures to draw attention to deficiencies and agreement on compulsion if voluntary codes do not work.

2.h. What are the best practices as regards internal corporate governance processes to ensure proper reliability of the disclosed information?

This needs to be considered in relation to the measures requiring independent directors, separation of Chair and CEO, and adherence to international auditing and assurance standards. An openness to shareholder and other stakeholder needs, and a willingness to respond to them, will help to improve reliability of the disclosed information. In addition, we recommend that regulation should, where possible, not prescribe, but provide principles.

2.i. What is the role of specific ESG investment instruments, like green bonds?

The IFoA supports the development of the green bonds market in principle. However, we are cautious about too great a focus on specific ESG-labelled investment instruments. Rather, there is no significant demonstrable pipeline of suitable investments for asset owners to assess for their portfolios and we would highlight the possibility of a greater focus on ESG issues in, for example, infrastructure projects generally.

One perspective we suggest could be helpful is to see the ESG lens as the investor equivalent to the corporate sustainability lens. Investors seek to avoid “wasted” capital expenditure and companies should seek sustainability on a long term basis, taking account of ESG issues.

3.a. What should an appropriate long-term risk assessment methodology look like? Please indicate some examples of good practice.

Traditional asset allocation models in investment management can also be viewed as risk models. The approach used by Mercer combining these with Integrated Assessment Models (IAMs) in “Investing in a Time of Climate Change” is one example of good practice.

3.b. Are there specific barriers, other than those of a regulatory nature (see question 9) for investors to integrate medium-to long-term risk indicators, including ESG matters in their risk assessment? If so, please indicate what you consider to be the main barriers.

The widespread use of quarterly investment performance reports encourages focus on short-term financial metrics by both institutional investors and asset managers. Institutional investors may feel pressure to address promptly any apparent under-performance, to avoid potential criticism from beneficiaries or third parties, which exacerbates this short-term focus.

Active investment management tends to be focused on alpha, i.e. excess returns to a capital markets index benchmark through active management. This focus, reflecting the perceived view of their clients (institutional investors), is not naturally a long term risk view.

Institutional investors’ investment paradigms (though they are slowly evolving, in some cases) tend to be implemented through traditional finance theory, which finds it difficult to incorporate long term ESG risks in a financial framework. For example, if carbon asset risk cannot yet be priced, as we assert, how can it readily be incorporated into a financial risk model?

There can still be confusion as to whether taking account of ESG issues is consistent with the fiduciary duty of institutional investors such as pension fund trustees. Some lawyers do not seem to appreciate that ESG issues have a financial dimension which institutional investors need to take into account.

4.a. When selecting and remunerating asset managers, how do institutional investors take into account asset managers' integration of ESG issues into investment strategies? What are the best practices in this area?

Institutional investors will typically award (a) passive investment mandates (against standard benchmarks) where fee/price is important, or (b) active investment mandates where the focus is on added value relative to a standard benchmark. In the former case, engagement with investee companies on ESG matters is arguably crucial as the sell option is unavailable, although there may be little intrinsic incentive for the asset manager to undertake such engagement. In the latter case ESG issues are likely to be integrated, to varying degrees, implicitly or explicitly in the decisions about which assets to hold and may also be integrated in engagement activities.

We suspect many institutional investors assume that asset managers are integrating ESG issues and exercising ownership responsibilities as a matter of course and so do not make this an explicit part of the selection process. However, investment consultancies are likely to include an assessment of managers’ ESG approaches and credentials in their manager research, which will in turn influence their clients’ selection decisions. We understand that some investment consultancies are now explicitly including ESG in their manager ratings.

Our understanding is that it is rare for ESG integration to be explicitly reflected in the remuneration (fees) paid by institutional investors to asset managers. These fees will reflect client (institutional investor) goals. If those goals only modestly incorporate ESG performance and active ownership criteria, as we suggest is the case, then this is a logical commercial position for an investment management firm to take. The method of remuneration of the firm is likely to be transmitted in the way that remuneration is distributed as compensation *within* the firm. Best practice might be gleaned from some responses under the PRI reporting framework, although much of this information is likely to be viewed as commercially sensitive and confidential. There are some asset managers who specialise in ESG tilted strategies, and in these cases, there may be explicit recognition.

4.b. Is ESG performance and active asset ownership taken into account in the remuneration of the executives and/or board members of institutional investors? What are the best practices in this area?

We are not aware of evidence to suggest that institutional investors' remuneration practices reflect these factors, but specific institutions may be able to inform the EU of their (likely, confidential) practices.

5.a. Do you think that the lack of scale or the lack of skills and resources of some institutional investors may affect their ability to integrate ESG factors in investment decision-making and engage on such issues? If so, how? Please provide evidence if possible.

Lack of scale typically leads to a lack of resources and a lack of resources may hinder institutional investors in some cases. However, more importantly, a lack of openness to long term risk awareness is likely a greater barrier. This is being tackled, and it is a slow multi-year process, by some institutional investors through the development of investment beliefs which can be viewed as going beyond traditional finance theory. These investment beliefs can reflect the influence of a wider range of stakeholders (current society, and the society in which the beneficiary will in future spend their, for example, pension payments). Investment beliefs that reflect such influences can lead to the development of more robust investment policies. An example is the (UK) Environment Agency Pension Fund's "Policy to Address the Impacts of Climate Change" which references alignment to a 2^{o}C world.

Asset managers will typically seek to access and develop the required resources to build a sustainable business, dependent on client demand.

5.b. Please indicate measures/practices that have contributed to enhance institutional investors' capacity and ability to integrate ESG factors in investment decision-making and engage on such issues.

- United Nations Principles for Responsible Investment
- Portfolio Decarbonisation Coalition
- Institutional Investors Group on Climate Change
- Carbon Tracker Initiative
- Corporate disclosure standards, such as the Global Reporting Initiative, the Sustainability Accounting Standards Board and the International Integrated Reporting Council
- CDP
- Various work streams and resulting reports seeking to demonstrate that fiduciary duty should be interpreted more widely than is often current practice.
- Climate and Pensions Legal Initiative and Commonwealth Climate Law Initiative which raise the possibility of legal risk.
- UNEP FI Initiatives including the Inquiry into a Sustainable Financial System
- Bank of England Governor Carney's Lloyd's Speech (Sep 2015)
- Multiple NGO initiatives in various parts of the finance sector
- UK Corporate Governance Code and UK Stewardship Code
- Stewardship Disclosure Framework from the UK's Pensions and Lifetime Savings Association.
- The Red Line Voting Initiative developed by the Association of Member Nominated Trustees

We would like to stress the long term nature of the changes in practice required. We support regulation that encourages good behaviour, yet in the financial sector there are relatively few readily available hard metrics for regulation. This means that both culture and evolving practice are important. The interventions aspects of systems theory suggests that self-organisation (as illustrated by many of the initiatives listed above) are more powerful in changing systems than rules/regulation.

6.a. To what extent can good internal governance of institutional investors, such as mechanisms aiming to align interests between beneficiaries, board and key executives, influence their ability and willingness to integrate ESG factors in investment decision-making and engage on these issues? Please provide evidence or good practices if possible.

We believe good internal governance can have a significant influence on institutional investors' ability and willingness to integrate ESG factors in investment decision-making.

Institutional investors will often have a board (e.g. pension fund trustees) which is directly accountable to beneficiaries with some degree of fiduciary duty. Some institutional investors (e.g. other savings institutions) will be more in the nature of product providers, and ESG influences will typically be less, often with no or little fiduciary duty influence. Some UK pension funds involve their beneficiaries in investment issues, for example the Universities Superannuation Scheme, and recently activists have had success in persuading local authority pension funds to divest themselves of some "fossil fuel" investments. A number of investment consultants have undertaken research on investment beliefs as a tool to support decision making.

6.b. Do beneficiaries of pension funds and other institutional investors with long-term liabilities obtain sufficient and clear information about how the fund or investor is managing ESG risks? Can they give their opinion/be consulted on these aspects? Please provide examples of good practice.

The provision of such information is varied due to both demand and supply issues, but typically such provision is modest. In some cases, unless there is demand from beneficiaries, the issue is unlikely to arise as an important consideration. However, although it may appear as if there is a lack of demand, feedback from IFoA members suggests that beneficiaries might find this information valuable if it were presented to them.

In the UK, small but growing numbers of beneficiaries are contacting their pension funds about ESG risks, often prompted by campaigns run by organisations such as ShareAction, 350.org and The Guardian newspaper. The responses we have seen tend to be vague and often reveal confusion about pension fund trustees' fiduciary duties in this area (e.g. inconsistency with, or lack of awareness of, the UK Law Commission's 2014 guidance on this topic). It is rare for beneficiaries to be consulted on ESG matters. As an example of research in this area, we refer you to ShareAction's 2013 report "Engaging Savers with Stewardship and Responsible Investment".

We note the pension regulations in Ontario, Canada which require institutional investor reporting to beneficiaries on a Comply or Explain basis.

6.c. Are beneficiaries interested in matters referred to above? Please provide evidence if possible.

Please see our response to 6.b.

7.a. Is there sufficient long-term oriented, reliable and relevant external investment research? Are there barriers to good quality external investment research on ESG risks and opportunities? If so, please explain. What role, if any, do financial incentives or conflicts of interests of some service providers play?

Sufficiency is determined by the size of demand. If the demand is modest then it could be argued there is insufficient research (because of insufficient demand) from a public policy perspective.

Institutional investors are the natural long-term oriented investors. However, they tend to focus on strategy and the employment of asset managers and/or the specification of investment mandates. Investment research tends to be targeted at asset managers, less so at institutional investors.

We note that the ESG research market has matured over the last decade with key players including MSCI, Bloomberg, Sustainalytics and Thompson Reuters. They are supplying research to large portions of the institutional investor community. Institutional investors on the other hand do not tend to buy research unless they have in-house asset management teams.

We also note that a further barrier to investment research on ESG risks is the nature of current disclosure initiatives. These are limited in scope or voluntary in nature and as a result there is inconsistent information and data.

7.b. To what extent do investment banks, investment analysts and brokers provide information on medium-to long-term company performance, including corporate governance and corporate sustainability factors, when they make buy, sell and hold recommendations to investors?

Please see our response to 7.a.

7.c. To what extent do investment consultants consider the asset managers' approach to ESG issues and active asset ownership when advising institutional investors about the selection of asset managers?

We refer you to our response to 4.a and the Working Paper *Investment Consultants and Green Investment: Risking Stranded Advice?* published by the Stranded Assets Programme at the University of Oxford’s Smith School. A member of the IFoA is on the Advisory Panel of the Programme.

7.e. To what extent do credit rating agencies take medium to long term performance of companies, including ESG performance, into account in their ratings?

There are a number of initiatives in this area, though we note the users of credit rating agency services are typically asset managers, not institutional investors.

8.a. Do you know of initiatives that led to more sustainable and responsible investment from non-professional investors? Please provide details about them.

We would argue that institutional investors and asset managers should be professional investors and therefore we interpret this question as referring to citizen savers. There is a wide range of initiatives, often led by NGOs, seeking to increase the demand for responsible investment. Please see our response to 6.b. We also note the influence of As You Sow (a US-based NGO) and the “Vote Your Pension” platform from the Asset Owners’ Disclosure Project and SumOfUs. These initiatives may seek to influence asset owners as well as citizen savers.

9.a. Are there legal or regulatory constraints likely to significantly and unduly prevent or discourage investors from taking a long-term view in their investment strategies and decisions and from investing in a sustainable way? If so, please provide details.

Short term regulatory and financial measures in both the insurance and pensions markets may act as a blocker rather than an enabler to ESG friendly investing. For example, capital constraints for insurers, and accounting methodologies such as IAS19 for pensions, tend to emphasise immunisation of liabilities and a 'mark to market' approach to valuing assets. These measures encourage investors to take a short term perspective. Instead, regulators and governments could move towards greater tolerance of contra cyclical strategies, which in turn could support ESG friendly investments underpinned by longer term perspectives. Investment in less liquid investments such as property, infrastructure, timber and farmland could benefit particularly from this kind of attitudinal shift.

A further main barrier to taking a long-term view is a narrowly financial interpretation of fiduciary duty. As noted in our response to 5.b, there are various initiatives seeking to demonstrate that fiduciary duty should be interpreted more widely than is often current practice. In the UK, the Law Commission and the Department for Work and Pensions concluded that, in relation to pension fund trustees, this did not require a change in law but rather greater clarity and guidance around the current legal position.

We also note that, while pension funds usually have liabilities which extend many decades into the future, they are (rightly) required to monitor their position on a regular basis. For example, most defined benefit schemes must assess their funding position at least annually and keep under review the ability of their sponsoring employer to provide additional funding if required. This encourages a shorter-term focus although there is considerable flexibility normally available to employers in meeting additional liabilities.

9.b. Do you believe that there are any barriers to the understanding by institutional investors and asset managers of their fiduciary duties that would not enable them to appropriately take ESG factors into account in their investment decisions? Please explain.

As alluded to in our responses to 6.b and 9.a, there is still considerable confusion about the current legal position relating to UK pension fund trustees' fiduciary duties in relation to ESG investment. Whilst the Law Commission's 2014 guidance has helped a little, awareness of this guidance is relatively low. More high profile endorsement of this guidance, for example by the UK Government and The Pensions Regulator, would help. More generally, professional qualifications and training (including Continuing Professional Development materials) for institutional investors, asset managers and their advisers could give greater emphasis to fiduciary duties and ESG.

Whilst institutional investors may have fiduciary duties (and there may be nuances between common law and statute law jurisdiction), asset managers' duties are often contractual, and the position with regard to fiduciary duty may be less clear.

The main barrier for institutional investors is likely to be the mind-set needed to invest over a sufficiently long time horizon.

10.a. Are you aware of any other incentives or obstacle(s) with a significant impact? If so, which ones?

The impact of regulation could be enhanced by adopting a systems approach, and we would highlight the following for consideration:

- Regulation can encourage long term thinking, therefore regulators and policymakers should focus on stimulating a long term perspective within the long term savings/investment/capital system.
- Institutional investors are the natural organisations in the system to take a long term approach and develop long term thinking.
- If they do this, it will drive long(er) term thinking and behaviour in their suppliers (asset managers, and others).
- There may be some functions in the system that are more attuned to a long term perspective than others. The actuarial profession is associated with long term risk assessment, and we note the Environment Agency Pension Fund reference to its actuarial valuation and funding policy in its "Policy to Address the Impacts of Climate Change".

- Regulators and policymakers should consider initiatives which encourage the development of long term thinking and thus behaviour.

We note the new requirements in this area that are included in draft amendments to the IORP and Shareholder Rights' Directives, including consideration of ESG factors in investment decisions, inclusion of social and environmental risks relating to the investment portfolio in an IORP's risk management system, and development of a shareholder engagement policy. These have significant potential to encourage greater integration of ESG issues and active ownership practices into investment processes.

10.b. Would you consider further increase in sustainable investments if market or regulatory conditions for sustainable investment would be more favourable? If so, please provide estimations, if possible.

Whilst the IFoA is not an investor, we suggest that addressing the issues raised in our response would assist "sustainability" in the long term savings financial sector.

If you have any further questions or would like to meet to discuss the points raised in this response, please contact Morgan Slebos, Policy Manager, in the first instance at morgan.slebos@actuaries.org.uk or 020 7632 1473.

Yours sincerely,

Nick Salter
Immediate Past President, Institute and Faculty of Actuaries