Institute and Faculty of Actuaries

Interim report of EU High-Level Expert Group on Sustainable Finance

IFoA response to European Commission

20 September 2017

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.

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Submitted online: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en#high-level-expert-group-on-sustainable-finance

Your opinion

Question 1. From your constituency's point of view, what is the most important issue that needs to be addressed to move towards sustainable finance? (sustainable finance being understood as improving the contribution of finance to long-term sustainable and inclusive growth, as well as strengthening financial stability by considering material environmental, social and governance factors)

What is the most important issue that needs to be addressed to move towards sustainable finance?

The IFoA believes that the most important issue to address is embedding a shared sense of objectives in finance, and to implement appropriate risk management around these objectives.

Objectives have arguably been set with the Sustainable Development Goals (SDGs) and climate change objectives agreed at COP21. However, in reality the business practices of organisations may not always align with the SDGs and the statements they are making.

The key action we suggest to support this is implementing a policy framework including:

- Setting an appropriate price on carbon. Fossil fuel subsidies and the lack of an effective carbon price distort the market. We urge the HLEG to send a clear message about the need to remove these distortions.

- Mandating fiduciary duty to consider environmental, social and governance (ESG) factors.

- Being mindful that the distinction often made between financial and non-financial/ESG risks can be unhelpful if this is simply based on timeframes (with non-financial risks potentially occurring over a longer term not considered as financial, even though they will ultimately impact financial performance).

- Improved transparency and disclosure of ESG risk factors, such as the Task Force on Climate-related Financial Disclosure's (TCFD's) recommendations and France's Grenelle II law. This will enable better capital allocation decisions by those entrusted with lending or investment decisions, and better governance of these factors by companies.

The following questions cover selected areas that are addressed in the recommendations (chapter VI) of the interim report, which the expert group considers to be crucial and would appreciate your feedback on:

Develop a classification system for sustainable assets and financial products

Question 2. What do you think such an EU taxonomy for sustainable assets and financial products should include?

> We believe that a taxonomy for sustainable assets could be helpful, but only as an adjunct to a wider, more purpose-driven framework, not as an end in itself. The SDGs would be a good example of such a framework. An EU taxonomy allied to the SDGs could enable regulators to tilt investment towards sustainable assets.
>
> We can see challenges with implementing such a taxonomy at the asset level, particularly over the long timeframes of some assets. Different financing required for an asset at different stages of its life will require changing classifications.
>
> Some assets may not be straightforward to rate, or there may be conflicts between the different SDGs. One example might be a building which is built to the highest possible environmental standards but is then let to a coal mining company.
>
> A taxonomy for financial products may be easier to implement as it would put the onus on the product provider to demonstrate its suitability. A quality certification system, or similar, could be introduced. This could build off a range of current initiatives such as the Asset Owners Disclosure Project and the Principles for Responsible Investment (PRI) to embed longer-term thinking and decision making into financial products.
>
> In the UK, several pooled fund investment vehicles have recently emerged which have clear objectives to support the transition to a 2 degree world. These products would appear to tick the boxes for Sustainable Finance.

Establish a European standard and label for green bonds and other sustainable assets

Question 3. What considerations should the EU keep in mind when establishing a European standard and label for green bonds and other sustainable assets? How can the EU ensure high quality standards and labels that avoid misuse/green-washing?

> The IFoA believes that the EU should be careful to embed flexibility when defining standards for sustainable assets. Even if there is prior consultation with investors, market experience is the key test of which asset qualities matter most to investors, and any standards should be flexible enough to take account of this.
>
> The EU should also seek to align where possible with major existing frameworks that promote high-quality sustainable assets. Examples are the SDGs mentioned in our previous answer, and the recommendations of the FSB.

We support standards which seek to encourage behaviour changes in market participants. For example, implementing the TCFD's recommendations will make it easier for investors to measure the climate impact of their portfolios.

Improving market participants' knowledge of such standards will reduce the risk of green-washing by companies. Introducing sustainability components into professional standards / education syllabi for all market participants would send a powerful signal.

Standards should also assess projects holistically. For example, it would be unhelpful to classify an asset as sustainable if its financing required secondary instruments, such as currency hedges, that would not meet the sustainability criteria in their own right. Another challenging area is derivatives, as their complexity make it difficult to assess if they have a positive impact on portfolios' sustainability.

Create "Sustainable Infrastructure Europe" to channel finance into sustainable projects

Question 4. What key services do you think an entity like "Sustainable Infrastructure Europe" should provide, more specifically in terms of advisory services and connecting public authorities with private investors?

We support the goal of connecting not only public authorities but also local community groups with private investors. This is necessary because there is often a mismatch between identification of infrastructure needs and the availability of 'shovel ready' projects in which to invest. The identification process often occurs at local level, but there is a need to aggregate small scale projects to create larger-scale investment vehicles with more stable expected income streams.

We believe it would be worthwhile for a European agency for sustainable infrastructure to focus on developing mechanisms that make green infrastructure project refinancing work more smoothly. Such mechanisms would take account of the different priorities and risk approaches of various institutional investors, such as investment banks and pension funds.

The report also touches upon areas for further analysis. The following questions focus on a selection of these, which the group would appreciate your feedback on:

Mismatched time horizons and short-termism versus long-term orientation

Question 5. It is frequently stated that the inherent short-termism in finance, especially financial markets, represents a distraction from, or even obstacle to, a long-term orientation in economic decision-making, including investments that are essential for sustainability. Do you agree with this statement?

Yes
~~No~~

~~Don't know / no opinion / not relevant~~

Question 5.1. If you agree with this statement, which sectors of the economy and financial system are particularly affected by the 'mismatch of time horizons'? What are possible measures to resolve or attenuate this conflict?

> This mismatch has a widespread impact and we would not single out particular sectors. We suggest there are a number of potential remedies that could be relevant across many sectors. As we note in the response to Question 1, we believe a risk management approach can encourage market participants to extend their time horizons and weaken the hold of shorter-term market perspectives.
>
> Improving clarity around the fiduciary duty of company directors would make them more accountable for their actions. Fiduciary duty should be understood in a broad sense, to encompass the long-term interests of the company and the creation of non-financial value, rather than to maximise shareholder value in the short term.
>
> In addition, provided the TCFD's recommendations on disclosure are widely adopted, this will put pressure on companies to demonstrate that they are engaging seriously with the changing expectations of asset owners to prioritise sustainability and long-term thinking.

Governance of the investment and analyst community

Question 6. What key levers do you think the EU could use to best align the investment and analyst community with long-term sustainability considerations in the real economy?

> One lever that the EU could use is regulation. The focus of capital and solvency frameworks, and directives such as IORP II, is on risks and the assets required to meet them. They are not political tools. Nevertheless, in practice they may enable the highlighting of long-term risks from assets that are not meeting sustainability measures. This in turn could encourage asset owners and managers to embed long-term sustainability in their investment strategies, portfolio construction and engagement with companies.
>
> While regulation is important, compliance cannot be taken for granted. The EU should therefore also encourage behavioural change. For example, clarifying fiduciary duty and requiring more and better disclosure by asset owners and managers will incentivise them to act consistently with their stated goals and beliefs, to avoid reputational risk or even litigation.
>
> We believe it is important for asset owners to take appropriate responsibility for their assets, even when they delegate significant authority to investment managers or consultants.
>
> An example is the relationship between life insurance companies and investment managers. Many investment managers are signatories to the PRI but for most, full ESG integration has yet to be achieved. Some insurers rely on the PRI membership and effectively delegate ESG to the investment manager, yet the investment mandates agreed between the two parties may not explicitly cover ESG.

A strong pipeline of sustainable projects for investment

Question 7. How can the EU best create a strong and visible pipeline of sustainable investment projects ready for investment at scale?

As mentioned in response to Question 1, we believe the key policy challenges to achieve a thriving sustainable investment environment are to remove the market distortions of fossil fuel subsidies and an inadequate carbon price. Tackling these would help to ensure that there are sufficient projects in the pipeline, of large enough scale, to kick-start a switch to the next generation of energy production. As long as subsidies are in place there is unlikely to be enough of an incentive to offer such projects for investment.

The points made in the response to question 4 are also valid. As, for example, power generation becomes increasingly decentralised, then a mechanism for combining small scale, community led projects to allow scale investors to purchase assets and support these developments, will be required.

Some innovation may be required. One investment approach that could be considered is to mandate a portion of an investment fund to specifically support small scale local projects, similar to the way in which the recently launched UK firm 'The People's Trust' is anticipated to operate. This company invests long term but envisages re-investing a small proportion of funds into local, community led projects, with a clear positive social impact.

Integrating sustainability and long-term perspectives into credit ratings

Question 8. What are some of the most effective ways to encourage credit rating agencies to take into consideration ESG factors and/or long-term risk factors?

Please choose 1 option from the list below

~~Create a European credit rating agency designed to track long-term sustainability risks~~
Require all credit rating agencies to disclose whether and how they consider TCFD-related information in their credit ratings
~~Require all credit rating agencies to include ESG factors as part of their rating~~
~~All of the above~~
~~Other~~

Question 8.1 Please specify what other ways you would deem most effective in encouraging credit rating agencies to take into consideration ESG and/or long-term risk factors.

We do not believe it is feasible to regulate credit rating agencies to take ESG factors into account. We suggest that if the customers of credit ratings agencies are pushing for better long term information on the sustainability of business models, not just short term (1, 3 or 5 years) probabilities of downgrade or default, that may incentivise the agencies to produce such information more effectively than a regulatory requirement.

We note that greater awareness by companies of ESG factors is leading some agencies to look at providing sustainable business model ratings. Unlike traditional ratings, these are longer term, and reflect the investors' desire for their capital to be resilient to potential changes in the way the company creates value. ClimateWise has advocated a role for the insurance industry in developing a climate resilience rating system which could be applied in many areas of business decision-making.

This could be applicable to assets backing long term liabilities, such as annuity portfolios. In the UK, firms can apply for a ‘matching adjustment’ under Solvency II regulations, which allows them to increase the discount rate used to value their liabilities, if they plan to hold assets to maturity to match the liability cash flows. Often, a considerable component of the assets is made up by corporate bonds. A resilience rating system could help firms take greater account of the long term sustainability or resilience of the corporate entities backing the bonds.

Role of banks

Question 9. What would be the best way to involve banks more strongly on sustainability, particularly through long-term lending and project finance?

We endorse the role of central banks in de-risking larger sustainable projects (p45 of report), through credit support and risk sharing.

Retail banks could have a stronger role at the local level, with a greater focus on lending for sustainable investment, as opposed to unsustainable consumption. This model has been achieved in Germany, where there are 1700 local co-operative banks and the Sparkassen savings banks lending in the public interest to the "Mittelstand" – the German SMEs.

We would support investment banks signing up to sustainable lending practices and disclosing more about how they consider sustainability in their lending.

We would also support tighter banking regulations, in order to limit money creation via bank lending (as the Bank of England and the Bundesbank have discussed) and the excessive consumption this encourages.

Role of insurers

Question 10. What would be the best way to involve insurers more strongly on sustainability, particularly through long-term investment?

Insurers have expertise in assessing long-term risk and should use these skills in developing their investment strategy, as some are already doing. Solvency requirements should also take account of the desirability of long-term investment approaches. However, the Bank of England’s Procyclicality Working Group (July 2014) highlighted the trend to reducing levels of equity investment by insurers and pension funds.

In Question 8.1 we referred to ClimateWise’s proposal for a resilience rating system. This could represent an opportunity for insurers, since it would require underwriting skills at its core. There are also related opportunities to embed sustainability in insurers’ products, such as providing long-term incentives to policyholders through multi-year insurance policies and profit-sharing insurance pools.

Insurers could also improve their engagement with employees and customers on sustainability, for example by embedding longer term thinking into their objectives, and communicating this effectively.

In practical terms, an appropriate policy and governance structure within each company, led from the top, should be cascaded down into products and investments. This should include the need to incorporate ESG and also a clear company position on engagement and stewardship. This should be incorporated into investment management agreements and reported on, allowing Boards to embed long-termism/sustainability and monitor progress against these objectives.

Social dimensions

Question 11. What do you think should be the priority when mobilising private capital for social dimensions of sustainable development?

The IFoA would encourage activity to increase awareness of social sustainability among specific groups, such as pension fund trustees, company boards and insurers.

We believe it is important to ensure that there is adequate financing and capital for local level initiatives.

We would also support the development of social impact metrics in mainstream investment management, which would help to integrate social finance within the range of potential investments.

Part of the solution may be better education and communication with customers. There is a high level of public distrust in business in the UK and with insurance companies in particular. Engaging customers through better communication around what their investments do to better the world could help to transform this relationship and fundamentally change the way in which people view insurers and their pensions.

Some of the Australian super funds have reported some success with infrastructure investments in terms of customer engagement. For example, customers who were made aware that their superannuation fund is an investor in a new toll bridge felt differently about paying the toll, knowing that this would be returned to their pension fund. Infrastructure also has the benefit of being a very tangible asset for customers to understand.

Other

Question 12. Do you have any comments on the policy recommendations or policy areas mentioned in the Interim Report but not mentioned in this survey?

None.

Question 13. In your view, is there any other area that the expert group should cover in their work?

As noted earlier, we believe the issues of fossil fuel subsidies and carbon pricing are crucial to any discussion of sustainable finance.

The group could also consider including discussions on education for finance professionals and consumers, and on setting the bar for entry as a player in the financial markets.