aba Arbeitsgemeinschaft für
betriebliche Altersversorgung e.V.

aba response
to the
International Organisation of Pension Supervisors (IOPS) Consultation „Supervisory guidance on the integration of ESG factors in the investment and risk management of pension funds“

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The **aba Arbeitsgemeinschaft für betriebliche Altersversorgung e.V**. - is the German association representing all matters concerning occupational pensions in the private and public sector. The aba has 1,100 members including corporate sponsors of pension schemes, IORPs, actuaries and consulting firms, employer associations and unions, as well as insurance companies, banks and investment managers. According to our statutes, our mission is to represent existing schemes as well as to expand coverage of occupational pensions independent of vehicle. We are a member of the European Association PensionsEurope.

Please do not hesitate to contact us if you have any questions:

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1. General points

- We welcome that the Guidelines are principle-based and voluntary in nature. This is the right approach considering the diversity of IOPS members.
- We also welcome that ESG factors are considered to be a subcategory of financial factors. This is an adequate definition when incorporating ESG factors in a prudential framework.
- Generally, we would like to emphasise that the final decision where to invest needs to remain with the pension fund, assets should not be steered into a certain direction.
- Since German IORPs are subject to EU legislation, we welcome all the references made to EU law. We note that with the transposition of the IORP II Directive, EU Member States have rules in place which to a large extent are already compliant with the proposed Guidelines.
- With the three Proposals for Regulations published in May 2018 by the EU Commission, a lot is happening at EU level regarding sustainable investment. Where relevant, we have made the connection to the discussion at EU level; where our position towards the EU proposals is of a general nature, we have included it in this document as well.

2. Background note

- We welcome that the Guidelines take existing legislation with ESG requirements into account, in particular IORP II. With the transposition period now over (13 January 2019), it is up to IORPs to ensure that they comply with the new legislation. The coming years will show what the new rules mean in practice and what their impact in terms of ESG will be.
- Regarding the Final Report of the EU High Level Expert Group on Sustainable Finance (mentioned in Nr. 2 of the consultation paper), we would like to point out that it was not published in August 2018, but in January 2018 (European Commission Press Release).
- With the Proposal for a Regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 (COM/2018/354 final), which is one of the three proposals published in May 2018, the European Commission is empowered to adopt delegated acts in the IORP II Directive. This proposal is supported by the ECON Report (even though the vote to maintain this Article in the proposal (Art. 10) was very narrow), the Council deletes the delegates acts for the IORP II Directive.

  We very much support the Council position, because delegated acts are not a suitable instrument for the regulation of IORPs. Delegated acts that regularly aim for full EU harmonisation do not fit into any directive that aims for minimum EU standards. Furthermore, delegated acts are limited to amending non-essential elements. The proposed delegated acts would amend the prudent person rule (Art. 19 IORP II), which is an essential requirement for IORPs. Essential changes to the IORP II Directive should always be carried out by amending the Directive itself through the ordinary legislative procedure, because this is the only way which adequately involves the Council and Parliament.

Another argument to reject the proposed delegation of power to the EU Commission is that the coherence the delegated acts are supposed to achieve with the UCITS, AIFM and Solvency II Directives is neither reasonable nor necessary. IORPs are not to be treated as pure financial service providers (see Recital 32 IORP II Directive).

Definitions

- We welcome that the definition of ESG factors is financial rather than ethical. The first and foremost goal of pension funds is to ensure that they can deliver the pensions the sponsoring companies promised. It is therefore adequate to focus on the financial implications of ESG factors.

3. Comments on the Draft Guidelines

I. ESG factors in the investment and risk management process

1.1. 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.

- This Guideline is already partly reflected in Art. 25 (Risk-management) and Art. 28 (2) h (Own-risk assessment) IORP II. Art. 30 (Statement of Investment Policy Principles) IORP II stipulates that IORPs have to prepare a statement of investment policy principles which includes how the investment policy takes into account ESG factors. However, the IORP II Directive does not prescribe any consideration of ESG factors in the investment process).
- The term „wealth-being" is used in the Annotation to Point 1.1 (Nr. 19). Maybe it is worth explaining the concept behind the term? We understand that this refers to the idea, that members and beneficiaries do not only attach importance to an occupational pension (wealth), but also to the way it is generated. If it is generated according to certain rules, this might create well-being. How would this translate into a supervisory framework?

  In Germany for example, member representatives are involved in the development of the ESG strategy. Coupled with disclosure requirements towards the IORP's members and beneficiaries, this seems to be sufficient.

1.2. 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.

- As mentioned in the Annotation to this Point, the IORP II Directive incorporates this Guideline already: Art. 19 (Investment rules) stipulates what the prudent person rule entails and clarifies in Art. 19 (1) b that „Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social and governance factors".

1.3. When pension funds offer investment options to members 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.

- ➢ We support *adequate* information to members and beneficiaries, that is where the added value for members and beneficiaries clearly exceeds the costs incurred when providing the information. Issues around information are also addressed in the IORP II Directive, see Title IV „Information to be given to prospective members, members and beneficiaries“.
- ➢ In Germany, occupational pension scheme members in general do not have a choice between different investment options. We consider this to be an important positive feature of occupational pensions: member representative, social partners or other professionals take decisions for which the individual member might not have the information, education or time needed to make an informed choice. Employee representative are also in a position to bring potential ESG preferences members and beneficiaries might voice into the decision-making of the IORP.
- ➢ From our perspective Guideline 1.3 applies to cases where returns are foregone in order to foster a certain objective, but it could also cover cases where investments in certain areas are excluded on purely ethical grounds. An example is the investment in companies producing cluster bombs: the investment does not carry extraordinary financial risks, but many pension funds exclude these companies because of ethical reasons.

  The Annotation in Nr. 21 refers to this case where decisions are not entirely based on financial factors. Since the financial impact of an exclusion could be minimal, there is no added value in trying to calculate the sacrifice of risk adjusted returns. However, it is of course important to inform (prospective) members about the exclusion itself. We therefore propose adding the term “significant” in the Annotation to Guideline 1.3:

  “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.”

1.4. 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.

- ➢ Our understanding is that an adequate risk-return profile is the first and foremost objective of a pension fund, any consideration of ESG factors should not trump this objective. This is reflected in the prudent person rule as laid down in Art. 19 of the IORP II Directive (see Art. 19 (1) b: „within the prudent person rule, Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors“).

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

1.5. 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.

- ➢ Generally we would like to stress that the final investment decision should remain with the pension fund. This prerogative should not be limited by negative lists, penalising certain investments etc. From our perspective, the exclusion of certain investments is counterproductive if the aim is to finance the transition towards a more sustainable economy. It is precisely in the „worst" activities where investors can make a difference by shareholder engagement and where investments are needed to make a transition. In other words, it should be avoided to push investors towards exit when voice can be an instrument of change.
- ➢ We welcome that this Guideline calls on supervisory authorities to avoid being overly prescriptive on how governing bodies should deal with ESG factors.

1.6. Supervisory authorities may, however, 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.

- ➢ Without doubt it is important to measure and monitor ESG or other emerging risks for a pension fund. However, pension funds should not be required to measure and monitor "when it is possible" (see last sentence of Nr. 25), but rather, where it is proportionate in terms of the resources used and the insights gained.

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

1.7. 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 how they integrate ESG factors in their investment and risk management process.

- ➢ Regarding the final sentence of the Annotation to Guideline 1.7 (Nr. 26): What is the objective of developing a heat-map of ESG related risks? What would it be used for? Would there be regulatory consequences of any kind?

  We would like to emphasise that we see severe consequences if such a heat-map was used as part of a prudential framework: ESG-related risks which are identified could be treated differently, e.g. in stress tests. This would create supervisory pressure on certain investments, leading investors to divest/not buy them anymore. De facto, this would have similar consequences as a black list. This kind of heat-map should therefore not be the basis for prudential requirements for IORPs.

Any heat-map that is designed in a way which de facto leads to a "blacklist" can trigger herding in the capital markets, resulting in large systemic risks (and damage to economies and markets). In addition it could remove capital from companies that have the greatest possible potential for improvement.

1.8. 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 on substantial financial factors, including ESG factors.

1.9. Supervisory authorities should require that, in their investment policy statement, a governing body or the asset managers of a pension fund disclose to its members information about the pension funds' 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.

- ➢ We understand that Guidelines 1.7 and 1.8 refer to reporting requirements towards the supervisory authority, and Guideline 1.9 to information to be given to the pension fund's members.
- ➢ Under Art. 30 (Statement of investment policy principles) of the IORP II Directive, IORPs have to publish (at least every three years) a statement of investment policy principles, which contains information on matters such as „investment risk measurement methods, the risk-management processes implemented and the strategic asset allocation with respect to the nature and duration of pension liabilities and how the investment policy takes environmental, social and governance factors into account."
- ➢ Regarding an ESG framework, we support transparency, which includes reporting to the relevant authorities, publication of certain information and information which is made available to members and beneficiaries. However, we are against any framework which seeks to influence asset allocation. Investment-decision-making is and should remain a core task of IORPs. Steering assets in a certain direction is counterproductive and should be avoided.
- ➢ At EU level, the Directive amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (Shareholder Rights Directive, (EU) 2017/828)) is addressing the issue of stewardship. Art. 3g (Engagement policy) and 3h (Investment strategy of institutional investors and arrangements with asset managers) are relevant for IORPs. The Directive i.a. requires institutional investors (which includes IORPs) to publish information on their engagement policy and how it has been implemented. Art. 3 (h) 2 addresses the relationship between institutional investors and asset managers, recognising that they have very different roles in the financial market. The Directive is, however, not prudential regulation.

IV. Scenario testing of investment strategies

1.10. 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 test should consider all substantial financial factors, including ESG factors. The scope and complexity of stress tests should be subject to the principle of proportionality.

- ➢ We would like to point out that the first EIOPA stress test for IORPs which contains ESG factors is being conducted in 2019. We very much welcome that the inclusion of ESG is qualitative in nature.
- ➢ The taxonomy which is currently being developed at EU level following the Proposal for a Regulation on the establishment of a framework to facilitate sustainable investment (COM(2018) 353 final) is also relevant in this context. The Technical Expert Group tasked with assisting the Commission in developing the taxonomy has adopted the NACE classification as a starting point. If this approach is further pursued we see a danger that the practical application of the classification will be a huge administrative burden for all financial market participants because it is very complex and currently not used by financial market participants. Ultimately, IORPs are likely to buy the needed expertise externally, which means additional costs for pension funds.

  We therefore support that Guideline 1.10 establishes that the complexity of stress tests should be subject to the principle of proportionality.

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