Inquiry: Design of a Sustainable Financial System

[CalPERS logo]

Rob Lake Advisors Ltd.

Financial Reform, Institutional Investors and Sustainable Development

A review of current policy initiatives and proposals for further progress

Pre-publication version of the Executive Summary for the PRI Policy Steering Committee, 7 September 2015

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The Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it will publish its final report towards the end of 2015.

More information on the Inquiry is at: www.unep.org/inquiry/ or from: Mahenau Agha, Director of Outreach mahenau.agha@unep.org

This report and acknowledgements

This paper provides perspectives and proposals on the relationship between institutional investors and sustainable development. It builds on a Discussion Paper prepared for a workshop hosted by the inquiry and CalPERS in June 2015 and incorporates issues raised at that event.

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Errors and omissions are the responsibility of the author. Comments or questions can be addressed to: Nick Robins, Co-Director of the Inquiry, nick.robins@unep.org or Rob Lake, rob.lake@roblakeadvisors.co.uk.

Disclaimer

Foreword

CalPERS is delighted to support the work of the Inquiry both through our Chief Executive Anne Stausboll's membership in its Advisory Council and through our particular encouragement for its work on behalf of institutional investors. As one of the world's largest investors, we have long been convinced of the need to think in terms of sustainability. Our institution needs to be sustainable in order to deliver the commitments on pension and health benefits we have made to our beneficiaries. This means our investment returns need to be sustainable. This in turn means the companies we invest in need to operate in a sustainable way. And this means the economy, the environment and the society on which they depend must be sustainable too.

This focus on sustainability is reflected in CalPERS' governance. Our Investment Beliefs, which form the framework for the strategic management of our portfolio, stress the importance of the environment and human capital for long-term sustainable value creation, and the need for us to consider risks such as climate change and natural resource scarcity as we make our investment decisions. Our board and staff work hard to ensure that our Investment Beliefs are brought to life in our day-to-day work, and woven into our relationships with our partners along the investment chain.

Much more needs to be done to encourage and enable investors around the world to give sustainability the importance it deserves. Different countries have different ways of doing things, so the details will vary from place to place. However, this report highlights the need for the legal frameworks to be right, and for the institutions to be right, if we are to combine delivering healthy long-term investment returns with a healthy environment and a healthy society.

At CalPERS we have no doubt that our focus on sustainability is entirely consistent with our fiduciary duty – indeed it is an essential part of it. Where doubts on this score remain, they must be dispelled. And we need institutions that have the knowledge, the skills and the ways of working that are required to embed sustainability in their investments – to manage the risks it brings, and to capitalize upon the opportunities if offers. We hope every country will reflect on how it can best address these challenges.

Of all the sustainability challenges we face, climate change is the most pressing. This report is being published just a few weeks before the Paris Climate Summit. At CalPERS, we earnestly hope the world's governments will reach an ambitious global agreement to address climate change. Bold action is needed in particular to introduce stable, reliable and economically meaningful carbon pricing; and to strengthen regulatory support for clean energy. This will enable us, as investors, to deploy more capital in support of climate solutions and help to mitigate the investment risks we face if action is absent or insufficient.

This report is an important contribution to the efforts that CalPERS and investors and governments around the world are undertaking to make the objective of the Inquiry – a sustainable financial system – a reality. We look forward to working with our fellow investors, with governments and regulators and with other interested parties to continue these efforts.

Henry Jones, Chair of Investment Committee, CalPERS

Messages and Executive Summary

Policy reform is critical for aligning institutional investors with sustainable development. Relying on voluntary action and enlightened self-interest by investors will not be sufficient to achieve sustainability goals. Proactive policy intervention is needed both in the real economy and within the financial system.

Sustainability demands a systemic, dynamic policy approach. Previous interventions to promote the environmental and social dimension of investment have focused principally on disclosure of policies and formal statements of legal duties. They have largely taken fundamental features of the design and operation of the financial system as given. The need now is for a more systemic and dynamic approach—an approach that builds institutional investment frameworks, investment institutions and an investment culture with sustainability at their core. Policy interventions that directly address institutional investors also need to be set in the broader context of action relating to the financial system as a whole – including financialisation and accounting standards.

Interventions focusing on sustainability and investment intersect with other pressing policy objectives. These include tackling climate change, long-termism, post-crisis economic recovery, securing retirement incomes for ageing populations, meeting energy, water and food needs, and public trust in the financial system. Policy can support existing market initiatives and fill the gap where markets will not deliver solutions.

Seven critical policy objectives hold the strongest potential for positive change: aligning institutional investment system design with sustainability; removing policy barriers; stimulating demand for investment that integrates sustainability; strengthening asset owner governance and capabilities; lengthening investment horizons; aligning incentives along the investment chain; and ensuring investor accountability.

Fourteen policy tools can help get us there: the design of pension systems; investment performance measurement; the legal duties of investment institutions; the legal duties of the directors of risk-taking financial institutions; solvency and risk regulations; prudential regulation; investor disclosure rules; corporate disclosure rules; fiscal incentives; rules on equity and credit research; investor rights, codes and stewardship; risk mitigation and market development for green assets; soft law sustainability frameworks; and professional qualifications and knowledge transfer.

In recent years, policymakers have pursued a wide range of objectives through interventions directed at institutional investors: protecting savers' financial interests; competitiveness; consumer protection; general economic welfare; social responsibility; protecting national reputation; and channelling capital to national policy priorities. In parallel, investors have built policies and organisational processes focused on environmental, social and governance (ESG) issues, and developed new tools to incorporate them into investment decisions.

This first generation of policy intervention – which has occurred mainly in developed markets - has focused largely on disclosure obligations and on statements on investors' core legal duties. Signs are now emerging of a second generation approach that is more dynamic, addressing not just 'what', but 'how'. In many areas there is strong synergy between sustainability and other policy objectives – including improving prudential regulation to protect retirement incomes and ensure financial stability; regenerating the real economy; and strengthening public trust in the financial system. Many ongoing trends with positive sustainability potential – such as efforts to strengthen asset owner governance and promote long-termism – are not driven principally by sustainability goals; however, they can make substantial contributions to them. A significant opportunity exists to maximise benefits in multiple areas by making the connections among policy objectives explicit.

At the same time, certain features of the high-level context within which institutional investors operate continue to undermine sustainability objectives. For example, defined contribution pension systems that encourage high levels of member choice may encourage investment strategies that focus on short-term performance to avoid the risk of losing members. More broadly still, the phenomenon of financialisation pressurises companies to give primacy to short-term financial performance, weakening countervailing signals from long-term investors who give greater weight to sustainable development.

To secure alignment between institutional investors and sustainable development, policy should pursue seven overarching **objectives**:

- **Align system design with sustainability:** the structure of pension systems in particular can create conditions that favour or discourage sustainability and long-term investment – as well as having differential outcomes for pension savers.
- **Remove barriers** in existing policy that hamper the integration of sustainability into the investment chain – e.g. in relation to investors' legal duties, solvency and risk management.
- **Stimulate demand** for investment strategies, advice, asset management, research and corporate disclosure that incorporate sustainability. Asset owners, as the principals in the investment chain, are the primary source of demand. Their requirements and expectations will shape what other parties supply.
- **Strengthen governance and capabilities**: Well governed investment institutions, most notably asset owners, with strong capabilities and an understanding of the implications of sustainable development for their core mission and purpose, are well placed to develop investment beliefs and strategies aligned with sustainability. They will generate demand for services from other parties in the investment chain that reflect sustainability. They will also be able to exercise more effective stewardship over companies and markets.

- **Lengthen investment horizons:** Investors who take a longer-term perspective are likely to attach greater weight to sustainability. Short-termism is driven by powerful psychological and behavioural factors that shape organisational and industry-wide incentives, structures, tools and cultures.
- **Align incentives:** All participants in the investment chain need incentives that focus on the appropriate balance between long- and short-term financial objectives, in ways that take account of sustainability. This requires: appropriate benchmarks; performance monitoring directed towards long-term value creation rather than short-term risk; well designed asset manager fees and pay; and executive remuneration at investee companies based on long-term performance metrics and sustainability.
- **Ensure accountability:** Investors with strong accountability to beneficiaries, customers and society at large will be attuned to stakeholders' mounting sustainability concerns and will have strong incentives to incorporate sustainability into their operations.

The extent of market failures in relation to sustainability suggests that using a wide range of policy measures is justified. Policy actions will need to strike the appropriate balance between the interests of investors and wider social and sustainability objectives. We have identified suitable **policy tools** in 14 key areas.

- *Pension system design*

  Pension systems should be designed to strike the optimum balance among adequacy and reliability of outcomes for savers (e.g. protection against large market movements that affect retirement incomes), affordability for public and private sector sponsors, and sustainable development (e.g. promoting long-term investment and allocation to illiquid assets). Allowing high levels of consumer choice and switching in DC funds may reduce long-term investment.

  Existing examples: new DC pension models are being developed (e.g. in the Netherlands and the UK) that may offer these features. Some existing DB funds have strong commitments to sustainability.

- *Performance measurement*

  The performance of institutional investment should be measured and reported by investors in terms not just of financial metrics, but also of environmental and social outcomes. Government should support the development of appropriate measurement and reporting frameworks.

  Existing example: carbon footprint reporting.

- *Legal duties – institutions*

Policymakers in all jurisdictions should ensure that definitions and interpretations of fiduciary duty and prudent investment enable and encourage investors to take account of financially relevant ESG issues and to focus on long-term performance and risk. The removal of quantitative investment restrictions and the introduction of the prudent person principle is an opportunity to align new rules with sustainability.

Existing examples: South Africa, UK.

Governments should give public sector pension funds, sovereign wealth funds and other state investment institutions formal sustainability obligations.

Existing example: Government Pension Fund Global, Norway; AP funds, Sweden.

- *Legal duties – individuals*

  Governments should consider giving directors of financial institutions that take risks that could damage financial stability unlimited personal liability for any harm caused.

- *Solvency and risk frameworks*

  Risk-based funding, solvency and accounting rules should be reviewed to ensure that they do not unintentionally disincentivise investment in infrastructure or other assets required for the green economy.

- *Prudential regulation for governance and risk management*

  Prudential regulators can strengthen investor governance, capabilities and risk management for sustainability in multiple ways. Addressing these areas can help to tackle the psychological and behavioural factors that create short-termist investment cultures.

  - Governments should incorporate sustainability into the mandate of prudential regulators – or regulators can incorporate it into their mission statements.

    Existing example: The Dutch regulator DNB has adopted a mission statement of 'safeguard(ing) financial stability and thus contribut(ing) to sustainable prosperity in the Netherlands.'

  - Prudential rules can require that investment institutions have the skills and capabilities to reflect sustainability in their investment strategies and risk management. Requirements to demonstrate that governing body members have appropriate knowledge and training can be introduced. Sustainability can be introduced into the definition of a 'fit and proper' person to be a governing body member.

    Existing examples: efforts to upgrade asset owner governance are ongoing in several countries, including Australia, Denmark, the Netherlands and the UK. Sustainability should be integrated into these efforts. At the same time, care is

needed to ensure that the benefits of board diversity, including member representation, are not lost.

- Regulators can consider whether some pension funds are too small and weakly governed to serve their beneficiaries effectively or to incorporate sustainability into their investments, and whether consolidation is warranted.

  Existing examples: Australia, Netherlands, South Africa.

- New forms of prudential disclosure focused on carbon and other sustainability risk in portfolios, investment beliefs, investment strategies and portfolio management (e.g. turnover) and can be introduced.

  Existing example: In 2015 the Dutch pension supervisor DNB has begun to investigate the activities pension funds have made undertaken in responsible investment.

- *Investor disclosure*

  Requirements to disclose and report on policies on sustainability issues can be introduced in markets where they do not currently exist.

  Existing examples: France requires investment institutions to disclose their carbon footprint. The EU Shareholder Rights Directive would require investors to disclose in areas including company engagement, voting, their use of company long-term performance information, and portfolio turnover.

  Institutions with a high profile or brand in countries with high sustainability awareness should strengthen their 'social license' through voluntary responsible investment reporting. Governments should encourage such reporting, for example by supporting award schemes.

- *Corporate disclosure and accounting standards*

  Investors operating globally need reliable, comparable information on companies' exposure and response to sustainability risks. Yet corporate sustainability disclosure remains inconsistent and fragmented across markets. The International Accounting Standards Board and the US Financial Accounting Standards Board should adopt harmonised standards for corporate reporting on material sustainability issues, drawing on the work of bodies such as the International Integrated Reporting Council. The International Organization of Securities Commissions can play a crucial role, for both equity and debt, in coordinating action by securities regulators globally to incorporate sustainability into listing standards. Governments can introduce sustainability disclosure requirements via other regulatory routes where this is more appropriate.

Existing examples: climate change disclosure requirements in the US; greenhouse gas disclosure rules in the UK; sustainability disclosure obligations on stock exchanges including Australia, Brazil, Canada, China, and the UK. Proposals are under consultation on the Hong Kong Stock Exchange.

- *Fiscal incentives*

  Fiscal incentives are widely used to address market failures in many policy areas. In the financial system, they are used to encourage retirement saving and, in some countries, to promote specific types of investment with sustainability benefits. Tax measures could be used to: reward long-term shareholders; slow portfolio turnover; mitigate risk in targeted green investments on a bridging basis until these investments are fully viable without policy assistance; or to reduce the speed and volume of transactions across the market as a whole.

  Existing example: the CEO of BlackRock has proposed that long-term investors should receive capital gains tax advantages.

- *Equity and credit research*

  Sell-side equity research currently gives little attention to ESG issues or the long term in general. This is in part due to inadequate demand for alternative research. However, the bundling of equity research and trading costs restricts supply by hampering independent research providers with a sustainability focus. In markets where this has not yet been done, governments should consider unbundling and requiring buy-side investors to prepare transparent research budgets.

  Existing example: unbundling has been proposed in the EU.

  Credit rating methodologies do not always incorporate sustainability transparently. Regulatory authorities should initiate discussions with credit rating agencies to encourage them to incorporate sustainability into their methodologies, and support alternative rating initiatives.

  Existing example: PRI is in discussion with rating agencies on the incorporation of ESG in rating methodologies.

- *Investor rights, codes and stewardship*

  Giving long-term shareholders additional voting or other rights (such as enhanced dividends) may strengthen incentives for long-termism. However, this is controversial among some investors. Governments should explore whether and how corporate governance rules can be used to promote long-term shareholding in ways that strike an appropriate balance between investors' interests and broader economic welfare and sustainability objectives.

Investors should promote corporate sustainability as active and engaged shareholders, through ongoing dialogue with companies; promoting and where possible requiring executive remuneration arrangements that are aligned with sustainability and long-term performance; and their approach to voting. They should also engage with policymakers on market-wide sustainability issues. Governments should actively involve investors in relevant policy dialogues.

Barriers to exercising shareholder rights and responsibilities should be removed, e.g. inefficiencies in the voting system, share blocking and proxy access restrictions.

Governments should consider making stewardship activity on behalf of all categories of end investor (pension, insurance, institutional, retail etc.) mandatory on a comply-or-explain basis. Failing this, they should encourage the development of market-based investor codes, covering not only stewardship but also the incorporation of sustainability into investment decision-making, dialogue with companies, and asset owners' relationships with their investment managers and investment consultants. Regulatory or self-regulatory monitoring of codes is likely to strengthen implementation and behaviour change. Government should also require transparency on the structure of executive pay.

Existing examples: stewardship and other investor codes exist in markets including Canada, Japan, Malaysia, the Netherlands and the UK. Transparency on the structure of executive remuneration is required (to differing extents) in markets including the US and the UK. Investor coalitions are intensively involved in policy engagement on climate change.

Risk mitigation and market development for green assets

To mobilise capital at scale for a green economy, risks need to be mitigated, returns enhanced and market infrastructure built. A range of suitable tools is now available, waiting to be deployed at scale. Examples include first loss provisions, credit enhancements, insurance and financing schemes with low risk for payment default, and green investment banks. The green bond market should be accelerated by including green assets within covered bond regulations, and building investor confidence by supporting the development of standards on eligible project categories and transparency on the use of proceeds. Financing mechanisms are needed to support small and medium-sized companies. Public agencies should issue and buy green bonds. Asset owners can make commitments to invest in green assets. Governments should give sovereign wealth funds green investment mandates, and work with institutional investors to develop investment vehicles that meet their risk-return needs.

Existing examples: asset owners and insurance companies that have made public commitments to invest in green assets include Alaska Permanent Fund, Allianz, APG, Aviva, Axa, Barclays, CalSTRS, Deutsche Bank, KfW, New Zealand Superannuation Fund, PGGM, TIAA-CREF, University of California and Zurich.

- *Soft law sustainability frameworks*

  The OECD Guidelines for Multinational Enterprises place expectations on investors to conduct due diligence on investees' compliance with the guidelines and to exercise influence for improvement where necessary. The OECD should continue and enhance its work to develop practical guidance for investors on how to meet these expectations.

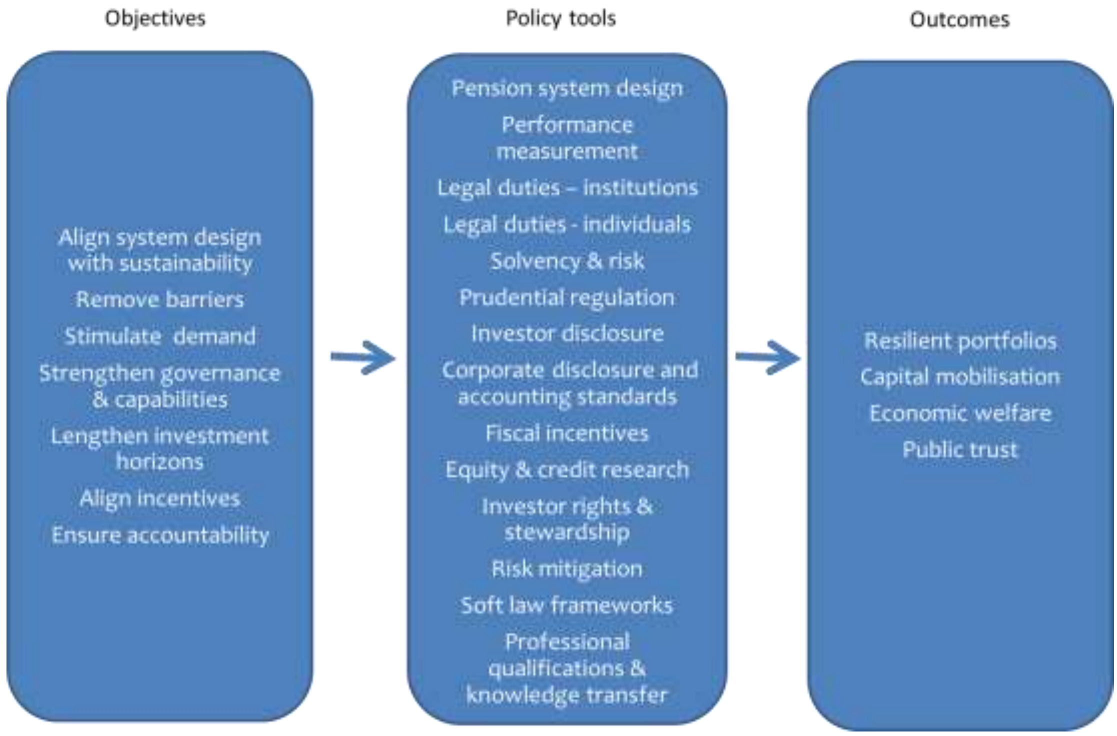
  Existing example: OECD Guidelines for Multinational Enterprises.

- *Professional qualifications and knowledge transfer*

  Developing and transferring new knowledge is critical to promoting the establishment of a new investment culture that values sustainability. Policymakers can play an important facilitating role. Examples include: supporting the incorporation of sustainability into professional investment training and standards, including initiatives currently under way by the CFA Institute and calling on professional bodies to develop appropriate training; enabling smaller asset owners to learn from the experience of large institutions; promoting investor governance training that incorporates sustainability; and, supporting research on the financial implications of sustainability issues over different timescales.

  Existing examples: CFA Institute programme on ESG issues; Focusing Capital on the Long Term; Principles for Responsible Investment Academy.

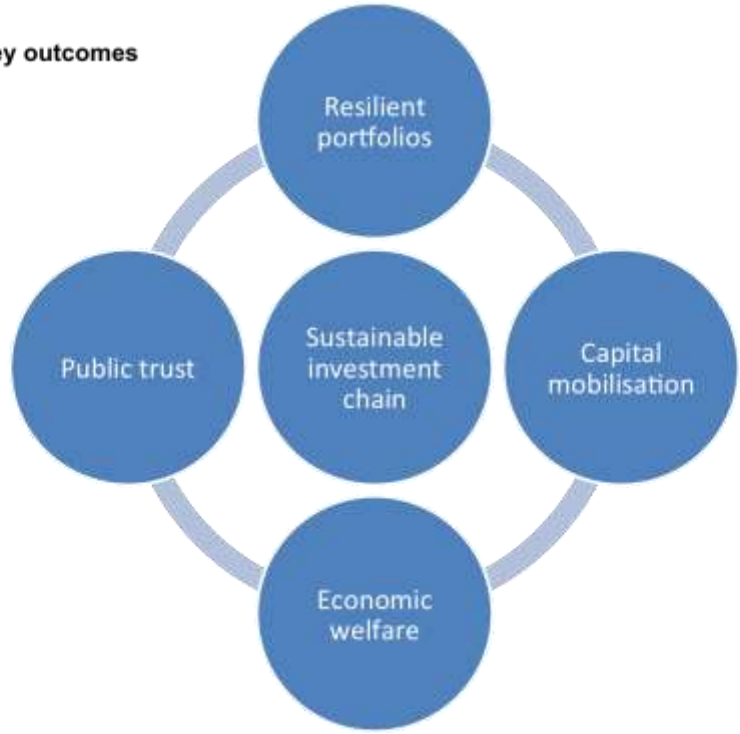
Figure 1: The path to a sustainable investment chain



Action in these areas will deliver four main **outcomes**:

- Resilient portfolios that allocate capital efficiently on the basis of sustainability factors and are supported by robust stewardship
- Capital mobilisation to support the low-carbon transition and other sustainability objectives
- Increased economic welfare as a result of more long-term investment
- Restored public trust in investors and the financial system.

Figure 2: Key outcomes



The policy frameworks relevant to the agenda set out here are fragmented both geographically and across multiple sectors of the institutional investment landscape. Solutions need to be flexible and tailored to highly diverse local circumstances. In many cases action will have to be taken at the individual national – or even sub-national – level. At the same time, numerous opportunities exist for international collaboration. For example:

- Prudential regulators can share experience and develop effective approaches through the International Organisation of Pension Supervisors, the OECD and the World Bank.
- The OECD could coordinate international action to harmonise interpretations of fiduciary duty in relation to sustainability and ESG issues.
- The OECD and the G20 can ensure that their ongoing work to promote long-term investment takes particular note of the need for green investment, for example in relation to any unintended consequences of solvency and risk-based funding rules.
- The EU has substantial potential in many areas discussed here – including the IORP and Shareholder Rights Directives and the Capital Markets Union.
- IASB and FASB can work together to incorporate material sustainability issues into accounting standards.
- IOSCO can promote action by its members to require corporate sustainability disclosure.
- The OECD can work with the World Bank and the IMF to develop global perspectives on key issues raised in this paper.

- The International Forum of Sovereign Wealth Funds can continue its exploration of sustainability and ESG and work towards producing a best practice guide for its members.
- Work is already underway at the OECD to develop guidance on the expectations on investors under the Guidelines for Multinational Enterprises.