Finance Watch response to the European Commission's public consultation on institutional investors and asset managers' duties regarding sustainability

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Finance Watch is an independent non-profit Members' association set up in 2011 to act as a public interest counterweight to the powerful financial lobby. Our mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and citizens. Our Members are civil society organisations and expert individuals, supported by a full-time secretariat.

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We agree to the publication of this response.

General comment

Finance Watch welcomes the opportunity to provide comments on the Commission's consultation document on institutional investors' and asset managers' duties regarding sustainability.

As highlighted in our recent blueprint on sustainable finance, we believe that making private financial institutions contribute to the transition to sustainable economies is not, on its own, sufficient and should be part of a more ambitious sustainable finance agenda. The foundation of such agenda must be detailed national plans (together with the required international coordination) to implement the Sustainable Development Goals (including the Paris Agreement). Economic regulation should then hardwire these plans into prices and incentives – mainly by pricing negative environmental, social and governance externalities and removing subsidies for activities impeding the implementation of the SDGs. The stability of the financial system should be improved, as its instability is still a threat to the economy as a whole. The presence and activities of public and mission-oriented finance should be increased substantially as these institutions embed the aim of serving objectives such as the SDGs in their business models. They also provide a higher degree of democratic accountability. Finally, private actors should have a duty to maximize their contribution to national and international plans (translated into standards and norms) to implement sustainability objectives. We do not see a conflict between investors' and asset managers' legal duty of pursuing the best interest of the beneficiaries and the consideration of sustainability factors. However, we believe that providing a more comprehensive definition of investors' best interest, encompassing explicitly sustainability factors, would give some important legal clarity to institutional investors and asset managers.

We also believe that the concept of best interest covers both financial and non-financial benefits.

In particular, we recognize that the incorporation of financially material sustainability factors in the investment decision making process is fully aligned with the financial return optimization objective.

We also believe that the involvement of beneficiaries should be strengthened with regard to the sustainability factors. When the sustainability factors are considered in the investment decisions, beneficiaries could be willing to sacrifice some financial returns for non-financial benefits. In other

words, we believe that the beneficiaries should be given the possibility to position themselves not necessarily on the efficiency frontier, given that the latter cannot reflect the utility the beneficiaries can derive from non-financial benefits.

Finally, we are of the opinion that among the sustainability factors, climate change needs a special attention. Climate considerations should always be implemented in the portfolios given that climate change will be a source of both systematic* and unsystematic risk** to the investment portfolios.

**Systematic risk (or market risk) is the risk that cannot be diversified. Examples of sources of systematic risk are volatility, business cycles, etc.*

***Unsystematic risk (idiosyncratic) is specific to a company or industry and it can be eliminated through diversification.*

Question 1: Do you think relevant investment entities should consider sustainability factors in their investment decision-making?

Yes

Please explain:

We believe that the relevant investment entities should consider sustainability factors in their investment decisions because they can:

- have a material impact on the portfolio performance and
- bring non-financial benefits to the beneficiaries.

Moreover, the economic system is characterized by a great number of market failures due to negative externalities. As a consequence, the returns on investments are created in a non-efficient system that is promoting the overproduction of goods associated with negative externalities. Because of the negative externalities, there is a tendency to overinvest in those types of economic activities, where the marginal private cost is lower than the marginal social cost. The consideration of sustainability factors in investment decision making would therefore contribute to redirecting the capital allocations towards more sustainable economic activities. The final outcome should be an aggregated output which is closer to the socially desirable quantity.

Question 2: What are the sustainability factors that the relevant investment entities should consider? (Please make a choice and indicate the importance of the different factors (1 is not important and 5 is very important). (Please refer to the definition in the Glossary).

Climate factors (these include climate mitigation factors as well as climate resilience factors) 5
Other environmental factors 5
Social factors 5
Governance factors 5
All.

Question 3: Based on which criteria should the relevant investment entities consider sustainability factors in their investment decision making?

The relevant investment entities should consider the sustainability factors based on the following criteria:

1) Consideration of sustainability factors should be seen as part of their legal duties. The current EU legal framework does not provide an explicit definition of the legal duties, however, Article 24 of MiFID 2 states that: *'investment firms shall act honestly, fairly and professionally in accordance with the best interests of its clients'*. Similar notions are present in other EU directives. Markets are very often not efficient and not all information relevant for the investment is available. Therefore, we believe that the interpretation of 'best interest' should also include consideration of sustainability factors on the basis that these can have a positive or negative impact on the returns on assets. In any case, the investment horizon needs to be aligned with financial liabilities of the beneficiaries. Therefore, the consideration of sustainability factors can be fully consistent with the return maximization and risk minimization objectives.
2) Among sustainability factors, climate change will be source of both systematic and unsystematic risks to the portfolios. Therefore, climate factors should be systematically considered in the investment decision making process. In particular the asset managers should implement TCFD recommendations - in the area of governance, strategy, risk (including exposure to litigation) management, metrics and targets - and align the portfolios with the 2 ° C scenario.
3) The 'best interests' need not be cast purely in financial terms. Ethical, social or charitable goals can be part of the asset management mandate. Other factors – in addition to return – increase the utility of beneficiaries and these are not reflected in the modern portfolio theory. In other words, the beneficiaries do not necessarily want to be on the efficient frontier. They can be willing to give up a share of return – given a certain risk – or they can be willing to accept more risk – given a certain return because other non-financial factors contribute to increase their utility. We therefore support the HLEG's recommendation in the interim report that the clients' expectations with regard to sustainability should be listed in the asset management agreement when appointing the asset managers.
4) The incorporation of sustainability factors in investment decision making could contribute to addressing market failures by redirecting capital flows towards more sustainable economic activities.

Question 4: Which of the following entities should consider sustainability factors in their investment decision-making? (Possibility to select several answers). If so, please indicate the level of impact that this would have (1 is the smallest impact and 5 is the highest impact).

All the investment entities reported above should consider sustainability factors in the investment decision because only a systematic approach that covers as many as investment entities possible can contribute to redirecting capital flows.

Occupational pension providers 5

Personal pension providers 5

Life insurance providers 5

Non-life insurance providers 5

Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF) 5

Individual portfolio managers 5

Question 5: To your knowledge, what share of investment entities active in the EEA (European Economic Area) currently consider sustainability factors in their investment decisions?

Occupational pension providers
Personal pension providers
Life insurance providers
Non-life insurance providers
Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF)
Individual portfolio managers

All or almost all
More than two thirds
More than half
More than a third
None or almost none
No opinion

Question 6: To your knowledge, which is the level of integration of sustainability factors by the different investment entities (active in the EEA)?

Occupational pension providers
Personal pension providers
Life insurance providers
Non-life insurance providers
Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF)
Individual portfolio managers

High integration
Medium integration
Low integration
No integration
No Opinion

Question 7: Which constraints prevent relevant investment entities from integrating sustainability factors or facilitate their disregard. Please provide the importance of the different constraints that you consider relevant (1 is not important and 5 is very important).

Lack of expertise and experience 4
Lack of data/research 5
Lack of impact on asset performance 2
Inadequate methodologies for the calculation of sustainability risks 4
Inadequate sustainable impact metrics 5
Excessive costs for the scale of your company 2
No interest from financial intermediaries no opinion
No interest from beneficiaries/clients no opinion
European regulatory barriers 4
National regulatory barriers 4
Lack of fiscal incentives 2
Lack of eligible entities 1
Other Integrating sustainability factors could be seen as inconsistent with the modern portfolio theory models (if assuming there is perfect information).

Please provide more details on what the constraints/reasons are and how they limit the integration of sustainability factors:

The standard models for calculating risk and return of a portfolio are not able to incorporate sustainability factors because, as discussed above, returns are created in markets characterized by imperfect information and inefficiencies (while models assume perfect information and efficiency).

In addition to the challenges posed by standard models and those reported in question 7, two additional obstacles are:

- The lack of standard mandatory format at EU level for reporting sustainability factors.
- The lack of uniform criteria to perform sustainability risk assessments.

Question 8: How challenging is it for relevant investment entities to integrate the different sustainability factors? (1 is not challenging and 5 is very challenging) - Please refer to the definition in the Glossary).

Climate factors (these include climate mitigation factors
as well as climate resilience factors)
Other Environment factors
Social factors
Governance factors
Others. We are of the opinion that for the time being it is not possible to give meaningful scores in the response to the question above. As reported in response 7, the current modelling approaches do not incorporate sustainability factors, there are no standard mandatory format

for sustainability factors and uniform criteria to perform sustainability risk assessments are lacking. Therefore, we believe that any precise score assignment would be arbitrary and would lack meaning at this time.

III. Policy options

Question 9: In which area should relevant investment entities consider sustainability factors within their investment decision-making? Please make a choice and indicate the relevance of the different areas (1 is minor relevance and 5 is very high relevance)

Governance yes, 5
Investment strategy yes, 5
Asset allocation yes, 5
Risk management yes, 5
Others

Question 10: Within the area of governance, which arrangements would be most appropriate to enable the integration of sustainability factors? (1 is the not appropriate and 5 is the very appropriate).

Specific sustainability investment Committee 5
Specific sustainability member of the Board 5
Sustainability performance as part of remuneration criteria 5
Integration of sustainability factors in the investment decision process 5
Integration of sustainability checks in the control process 5
Periodic reporting to senior management/board 5
Others

Please specify others:
The sustainability investment committee should be part of the investment committee in order to ensure consistency between all investment strategies and that sustainability factors are systematically taken into account in the investment decisions.

Question 11: Should insurance and pension providers consult their beneficiaries on an annual/periodic basis on their preference as regards sustainability factors?

Yes

Please explain:

The beneficiaries should be consulted at the beginning of the process when the scope of the investment mandate is being defined and on regular basis thereafter.

However, we believe that the consideration of sustainability factors should be seen as part of the legal duties and be systematically considered in the investment decision making process.

Question 12: Within the portfolio's asset allocation, should relevant investment entities consider sustainability factors even if the consideration of these factors would lead to lower returns to beneficiaries/clients in the medium/short term?

Yes

Please explain:

Firstly, we would like to highlight that in line with economic theory, public measures – such as standards and taxes – should be adopted by the public authorities to address market failures so that returns are created in efficient capital markets where externalities are internalized and full information is reflected in asset prices.

We are also aware that there are multiples sources of market failures and that public interventions have not been always effective enough in internalizing externalities.

Based on the above we understand that the question implies the public authorities' acceptance of several existing market failures, which ultimately have an impact on the return generation process.

While acknowledging the above, we believe that the investment strategy should be aligned with the best interest of beneficiaries. And the best interest can include both financial and non-financial returns.

We believe that the relevant investment entities should consider sustainability factors even if the consideration of these would lead to lower returns to clients in short / medium-term in the following three situations:

1) When the beneficiaries' utility depends also on non-financial benefits and their expectations with regard to the sustainability factors have been listed in the asset management agreement. They prefer to give up a part of their financial returns – given a certain risk – or they prefer to accept more risk – given a certain return because the incorporation of sustainability factors in portfolio structuring contribute to increase their utility.
2) When applying minimum sustainability standards which should be developed at the EU level.
3) When the investment entities consider climate change risk in the portfolio structuring, on the basis that climate change will be source of both systematic and unsystematic risk to investment portfolios.

Question 13: Within the area of risk management, does the current set of corporate disclosures provide the relevant investment entities with adequate information to perform sustainability risk assessments in respect of investee companies?

No

Please explain where the possible gaps are, if any:

The current directive on non-financial disclosure covers areas such as governance, strategy, risk management and metrics. However, the companies may choose between several reporting frameworks (international, EU based or national frameworks). So, on one hand there is no single standard format according to which companies should report non-financial information. On the other hand, it is up to the company to decide what type of information to include when describing the policies undertaken in relation to the listed areas (environment, social and employees, respect for human rights, anti-corruption and bribery). Information provided in the non-financial reports is therefore difficult for investors to compare. As a result, and given the current legal framework on non-financial disclosure, undertaking the sustainability risk assessment of investee companies could be challenging. But in any case, investment entities should always proactively engage with the investee companies to fill any data or information gap.

Question 14: Do the overall information or risk metrics available enable the relevant investment entities to adequately perform sustainability risk assessments?

No, but investment entities should perform sustainability risk assessment on the basis of both the available risk metrics and qualitative information. Moreover, as reported in response to question 14, they should always engage with the investee companies to fill any data or information gap when conducting the sustainability risk assessment

Question 15: Do you think that uniform criteria to perform sustainability risk assessments should be developed at EU level?

We think that both standard format for reporting sustainability factors and uniform criteria to perform sustainability risk assessments should be developed at EU level.

However, variations in approaches for performing sustainability risk assessment will be required depending on how the best interest is defined in the investment mandate and on the overall investment strategy.

Question 16: In case material exposure to sustainability factors is identified, what are the most appropriate actions to be performed by the relevant investment entity?

The types of appropriate actions depend on how the best interest of the beneficiaries is defined in the investment mandate and if the material exposure means a positive or negative impact on the returns.

If the best interest is defined purely in financial terms and the sustainability factor is expected to negatively impact return on an asset (or a category of assets), then the relative investment entity should review its investment strategy and analyse alternative asset allocations which would reduce material portfolio exposure to sustainability factor. If the sustainability factor is expected to positively impact return on an asset (or a category of assets), then the relative investment entity should review its investment strategy and analyse alternative asset allocations which would increase material portfolio exposure to sustainability factor.

If the best interest is defined in both financial and non-financial returns, as we believe it should be, then the degree to which financial returns can be sacrificed in favour of non-financial benefits (or the opposite) needs to be agreed with beneficiaries in the investment mandate.

In any case the investment strategies should be aligned with the minimum sustainability standards that should be developed at the EU level.

Question 17: Should relevant investment entities disclose how they consider sustainability factors within their investment decision-making?

Yes.

Independently from the investment mandate, the investment entities should disclose how they consider sustainability factors within their investment decision-making. In particular they should demonstrate not only how sustainability factors were considered in the decision-making process, but how the consideration of sustainability factors impacted the choice of the final asset allocations. The disclosure format and content would need to be adapted according to the audience (beneficiaries, supervisory authorities and general public).

If yes, what areas should the disclosure cover? Please make a choice and indicate the relevance of disclosure within the different areas (1 is minor relevance and 5 is high relevance):

Governance Yes 5
Investment Strategy Yes 5
Asset allocation Yes 5
Risk management Yes 5
Other

If yes, where?
Pre-contractual disclosure (e.g. prospectuses) Yes
Semi-annual/annual reports Yes
Periodic reports Yes
Website Yes
Newsletters No
Factsheets No
Marketing materials No
Others

Question 18: Which stakeholder groups would incur costs and which would benefit from integrating sustainability factors within investment decision-making by relevant investment entities?

Occupational pension providers
Personal pension providers
Life insurance providers
Non-life insurance providers
Collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF)
Individual portfolio managers
General public
Retail investors
Financial advisors
Service providers (index provider, research providers…)
Other stakeholders (please specify)

Please explain:

Occupational pension providers, personal pension providers, life insurance providers, non-life insurance providers, collective investment funds (UCITS, AIF, EuVECA, EuSEF, ELTIF) and individual portfolio managers, retail investors would incur costs and would also benefit. There may be increased staffing costs because more employees will be needed to perform sustainability risk assessments. On the other hand, they are also expected to benefit because investments that incorporate sustainability factors should contribute to a more sustainable capital allocation which would benefit the entire society.

Financial advisers are expected to benefit because they will have to expand the scope of the financial advice to include sustainability factors. However, they might also incur in higher labour cost, but overall, they are expected to benefit. As financial advisers, service providers are also expected to benefit.

Finally, integrating sustainability factors within investment decision-making is expected to benefit the general public because consideration of sustainability factors should contribute to decreasing investments in economic activities characterized by negative externalities and therefore improving the genera welfare of the society.