ESG

Many view Europe as the forerunner in adopting environmental, social and governance (ESG) principles into the pension and investment industries. Jack Gray **investigates what can still be improved despite recent progress**

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Room for improvement

The European pensions sector has seen a transformation that few could have predicted 15 years ago. With public and industry focus moving to climate and ethics-related issues in pension scheme investments, the continent has become the trailblazer for a more environmental, social and governance (ESG) aware model.

Regulation in this area has stepped up, with the European Union's (EU) IORP II Directive introducing new provisions requiring schemes and funds to consider ESG factors and risks in their system of governance, investment policy, risk management and member communication.

In 2019, the European Insurance and Occupational Pensions Authority (EIOPA) carried out an IORP stress test on how ESG risks were incorporated into risk management and investment policies.

"The reference date of the stress test was end-2018, at which time the IORP II Directive had not been transposed, and furthermore transposition had been delayed in a number of member states, so that it was expected that IORPs in a few member states would integrate ESG factors," states an EIOPA spokesperson.

"However, the vast majority of IORPs indicated to integrate all three 'E', 'S' and 'G' factors. This seems to be linked to national requirements and the push from members and beneficiaries of the IORPs."

Furthermore, KPMG's *European responsible investing fund market survey 2019*, which took place prior to the IORP II Directive's enforcement, found that the number of responsible investment funds increased by 27 per cent between 2016 and 2018, while assets rose by 12.5 per cent to reach €500 billion.

"Perhaps more important than figures, there are some qualitative trends of interest," comments Association of the Luxembourg Fund Industry (Alfi) deputy director general, Marc-Andre Bechet.

"Asset managers report that requests for a proposal from institutional investors, pension funds or insurance companies nowadays invariably require the provider to set out in detail its credentials in ESG and sustainable investing."

Beyond regulation

Despite these positive findings, KPMG's research also shows that the €500 billion in responsible investment fund assets represented just 3-4 per cent of the assets across all European funds.

"We are still on the journey towards having the financial sector better understand ESG issues," says Robeco head of sustainability integration, Masja Zandbergen.

"Regulation really helps because they have to think about the topic, but that is the first step. I'm very much in favour of getting knowledge and understanding rather than checking a box, so we need more than regulation."

Regulation can also pose challenges if it is not a Europe- or EU-wide initiative. Willis Towers Watson head of sustainable investment manager research, Amandeep Shihn, explains that differing legislation can add a "layer of complexity" to an already complex topic.

"The challenge with regulation is

that it is geographically different, and global investors may find it challenging to navigate different legal requirements when thinking about how to act in the best interests of investors." However, he says the challenges are not "insurmountable", as differing geographical regulations affect every part of businesses.

Education, education, education

One of the ways to go above and beyond the regulations set by governments and organisations could be to improve education for industry members and investors.

"The financial industry needs to understand what ESG issues there are and how they can implement them into thinking about businesses, which is all aimed at how you can make better investment decisions," Zandbergen adds.

"It should be a standard course in the financial and economic curriculum, for example at universities."

Alfi Responsible Investing Legal and Policy Committee chair, Nathalie Dogniez, believes that determining the sustainability of products will "remain a critical challenge" that the taxonomy and disclosure regulations are aiming to address.

She continues: "In order to properly implement these measures, intensive investors' education and up-skilling of sales forces will be required - not just demonstrating that, in fact, ESG integration brings additional performance, but also in order to assist investors in expressing their sustainability preferences."

Further education may help pension schemes position themselves in the rapidly changing market to ensure that outcomes for members and schemes are the best that they can be.

"We believe it's important asset owners evaluate their starting position to be able to facilitate their next steps for asset allocation, benchmark selection and manager oversight," notes MSCI executive director, asset owner and consultant coverage, Mark Guirey.

"To date, only a handful of pension schemes have reported on a Task Force on Climate-related Financial Disclosures (TCFD) basis and have done the analysis of the risks their portfolios face with the transition to a low carbon economy."

Reporting responsibility

Some argue that the key to increasing the implementation of ESG principles in European pension schemes is industry members taking responsibility in pushing for change and meeting sustainability targets. This could take the form of reporting on ESG-related activity, adapting investment strategies, or voting for or against management practises that support or ignore ESG issues.

"This systemic risk needs to be addressed by the whole system, not just the regulators, but everyone working together," says Zandbergen.

"Active ownership is an extremely important tool. You must also be ready to vote against management recommendations if you are serious about certain issues. If engagement does not work, then you need to be ready to show what you are serious about. If you are serious about creating wellbeing, you need to create non-financial goals next to your financial goals."

BNY Mellon Investment Management head of European institutional distribution, Olivier Cassin, agrees, saying: "The investment industry can still improve on ESG reporting and performance attribution. Active managers have a unique role to play here in focusing on bottom-up security or bond selection to demonstrate that ESG integration and sustainability are not labels, but a way to view the world that adds value to client portfolios."

Data and transparency

Commitment to ESG can naturally lead to more ethical management of pension schemes, with transparency at the heart of ethical improvements.

"Transparency is key, and the upcoming sustainability disclosure will impose demanding disclosure on all financial market participants and financial products, ranging from sustainability risks, to impact reporting and taxonomy alignment," explains Dogniez.

"Complete and reliable sets of data on the investment universe and investee companies will be required to prepare these disclosures. As of today, the main source of information remains the investee companies themselves, through their non-financial reporting.

"But very few companies are required to do such reporting and the information is not standardised nor subject to independent verification mandatory requirements."

Invesco global head of ESG, Cathrine De Coninck-Lopez, adds that communicating with members and adapting investment options can improve schemes' sustainability.

"ESG investment principles are founded on long-term sustainable value creation and therefore ESG investing is naturally aligned with the objectives of pension savings," she states.

"Studies have shown that pension savers put a high priority on aligning their pension savings with ESG principles, in some cases above returns. Pension investors are often not informed on how their pension savings are invested and default funds continue to be non-ESG options. In future, we would hope and expect to see default options increasingly moving towards ESG strategies." ■