# 2022 SUSTAINABLE FINANCE
WORLD PENSION ALLIANCE

WPA
WORLD PENSION ALLIANCE

# Contents

# Foreword from the Chair

Sustainable finance has the potential to change the world we live in. The evidence is mounting – the shift towards sustainable investment no longer demands a choice between profit-making and ethical decisions. We can achieve change with a unified mindset that prioritises sustainable finance considerations.

The World Pension Alliance (WPA) Sustainable Finance Paper provides an analysis of the transition in our five membership regions: the United States of America, Canada, the European Union, Australia and Latin America.  What the WPA Sustainable Finance paper makes clear is that pension funds operate in a complex environment that requires a coordinated effort to develop a sustainable global financial system. We have seen that the move towards greater sustainability for investors can be hampered by government resistance to progressive initiatives. Australia is no exception.

Globally, we have seen a shift in pension administration that mirrors the standards of investors – these are decisions informed by values. Throughout this paper you will read the individual journeys of regions, of their governments and regulators navigating the social change spearheaded by advocacy groups and the community.

Globalisation has heightened our awareness that responsible investing is a common and achievable goal. In 2006, the United Nations released its Principles of Responsible Investing, (PRI). It laid an essential building block to establish a broader sustainable finance framework that countries could work towards. The PRI continues to evolve, with signatory investors dedicated to transparency and alignment with the taxonomy of responsible investing. This was supplemented by the United Nations in 2015 releasing the Sustainable Development Goals – a blueprint for achieving a better and more sustainable future for all citizens of the world.

In Australia, the economic and social impact on environmental disaster ravaged communities has demanded a need for systemic change at all levels. Disclosing performance on sustainable investing will inspire an expanded ecosystem across the financial industry that will translate to consumer confidence and community resilience. Sustainable finance initiatives start with imbuing good governance practices at the leadership level of an organisation – one that prioritises sustainable development initiatives.

Much of the current discourse on sustainable finance focuses on climate change. Whilst climate change is important, sustainable finance embraces more than this and includes principles based on diversity, equity and inclusion. Sustainable finance stands for the proper treatment of our labour force, including the protection of children and others from forced labour. The WPA expects to continuously monitor this emerging area.

# Foreword from the Chair

The WPA recognises that sustainable finance practices are ever evolving, ever changing to reflect best practice initiatives. We can and should continue to strive to integrate our financial sectors into the building of resilient and sustainable global economies.

The fiduciary duties of pension fund trustees are not compromised by this goal. Mounting data shows the opposite – the best financial interests of investors can be met by socially responsible investing and economic vitality can thrive.

Pension funds should respond with confidence and continue to show that sustainable finance can offer higher returns for investors while delivering a better planet to live on. Doing so will support innovation and build a solid foundation for emerging and exciting technologies. This is the framework for the future.

One of the goals of the WPA's cross-jurisdiction working group is to share best practice findings and work towards alignment. This is the second part to the evolution of a sustainable finance framework – one that is committed to inclusiveness, cross-collaboration and aligning with the findings of industry and sustainability experts. The WPA member groups work diligently to engage with policy makers to educate and drive change. We hope that current and future governments take the opportunity to make a substantive contribution towards sustainable finance objectives and embrace sustainability goals.

The WPA represents more than 400 million people covered by retirement plans, and roughly 5,000 pension providers managing more than US$ 7 trillion, so there is an opportunity to exert significant influence. I want to thank all WPA members for contributing to the Sustainable Finance paper and encouraging a wider discourse on enhancing environmental, social and governance principles globally.

Sincerely,

**Eva Scheerlinck**
Chief Executive Officer AIST

# Introduction

While there is considerable divergence on the diagnosis and policy prescriptions, environmental quality, job creation and replacing ageing infrastructure are now at the core of the public policy debate in nearly every country. Although complexities are myriad and perspectives vary widely there is one common element in the discussion, the need to deploy vast amounts of investment capital and other financial resources in the pursuit of proposed solutions. Pension funds are perceived by politicians of all persuasions as essential to addressing these challenges because they constitute the largest source of investment capital in the world today.

Assets of pension funds in the Organisation for Economic Co-operation and Development (OECD) area are now estimated to exceed US$40 trillion[1], more than half of which are in US pension funds, with pension assets representing about 10% of worldwide financial assets. The American Society of Civil Engineers (ASCE) has estimated that the US alone requires US$4.5 trillion of infrastructure spending by 2025. The United Nations estimates that US$2.5 trillion is required to meet its recently established Sustainable Development Goals (SDGs) while the European Commission estimates that additional annual investment of €180 billion is required to reach climate and energy targets by the year 2030. The accumulated public debt in the US has recently exceeded US$22 trillion (roughly equivalent to current GDP). Central Banks simultaneously are endeavoring to unwind the unprecedented monetary stimulus and balance sheet expansion enacted to respond to the 2008 financial crisis. Both elements limit the capacity for public financing of new initiatives. Consequently, policy makers throughout the world continue to cast their eyes in the direction of pension funds.

Whether the assets accumulated to ensure the retirement income of a rapidly aging workforce will become the "White Knight" of the 21st century depends significantly on whether the regulatory regimes in which they operate can accommodate this role. This requires resolution of a fundamental tension between investing to achieve a social or economic purpose (e.g., job creation and climate change mitigation) and the basic precepts underlying the fiduciary (prudential) standards that are a foundation of the laws governing pension funds.

*Pension fund regulation is predicated on establishing a framework to ensure that assets are secure and able to fulfill the benefit promises for which they are dedicated.*

This requires resolving the "agency" challenges arising from the simple fact that parties making investment and administrative decisions have potentially different interests and incentives from the beneficial owners of the funds who generally have no expertise in such matters or the capacity to exercise effective oversight. In the early stages of financial market development, the "agency" challenge is resolved by the imposition of "legal lists" and quantitative investment limits that constrain investments to a small set of safe, but often lower yielding investments. As financial markets mature and deepen, the balance between security and yield have shifted, resulting in concerns about the "opportunity costs" of structural limits on investments. This has led to an evolution of regulatory regimes toward a more flexible regulatory regime predicated on a combination of procedural decision-making standards underpinned by restrictions on overt self-dealing and conflicts of interest.

Directing pension fund assets toward issues deemed to be socially or economically desirable has also become inextricably intertwined with the standards applicable to how pension fund managers exercise the ownership rights derived from their investment in corporate equities. Equity ownership accounts for roughly half of the value of portfolios in developed countries like the USA and the European Union (EU). This has been particularly the case in the USA as pension funds are faced with many proxy votes affecting the activities of major corporations. An important example of the increasing conflation of proxy voting and environmental, social and governance (ESG) issues is the current controversy regarding the role that pension funds play in imposing a shareholder vote at, the world's largest listed oil company, to adopt a corporate strategy consistent with the Paris Climate accord and how pension funds as shareholders may be required to exercise their voting rights if such a vote transpires.

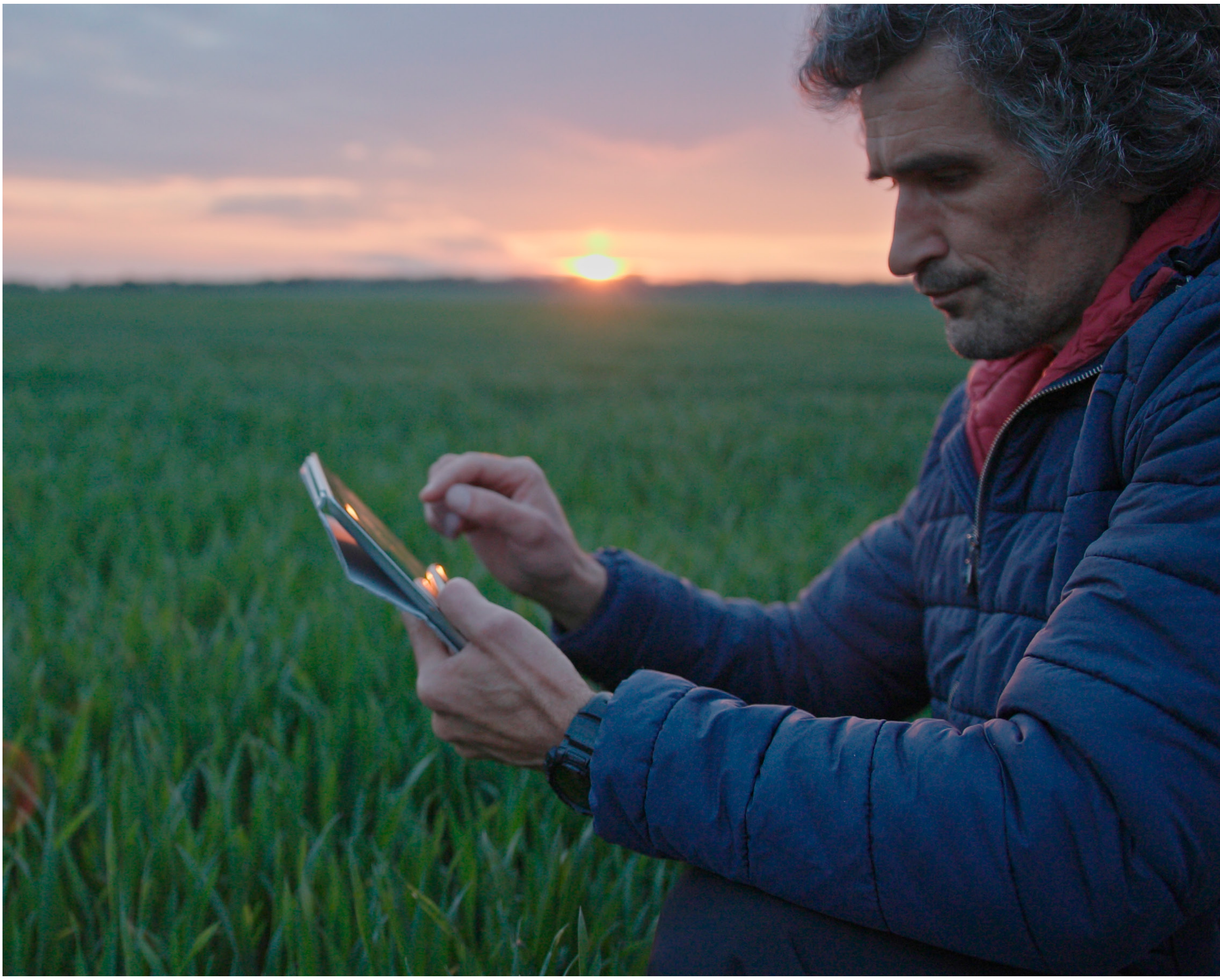
*In both the EU and the USA, the legal standards are derived from reliance on the "prudent person" regulatory framework, originating in English Common law as far back as the Crusades though continually recast to address changing conditions.*

This standard relies on a qualitative assessment of the capabilities and procedures employed by parties assigned responsibility for investment decisions. The Prudent Person (or perhaps more accurately Prudent Expert) approach relies on a trinity of:

1. Procedural standards
2. The requirement that the security and maximization of promised benefits be the "exclusive purpose" of investment decisions and
3. Requirements for the diversification of investments to manage risks.

All three of these precepts require resolution and clarity if pension funds are to be able to remain within the necessary protective regulatory framework while simultaneously achieving the desired social and economic outcomes.

More recent efforts to integrate a Prudent Expert framework into continental European legal systems, derived significantly from the tradition of the Napoleonic code, has imposed some challenges, and has resulted in pension regulatory frameworks that can be perceived as a hybrid. The following discussion provides a brief overview of the issues and initiatives in the US and the EU now underway in the effort to address pressures to incorporate a broader set of social and economic considerations into the rubric of what is increasingly referred to as ESG factors and how pension funds are required to exercise their proxy voting responsibilities.

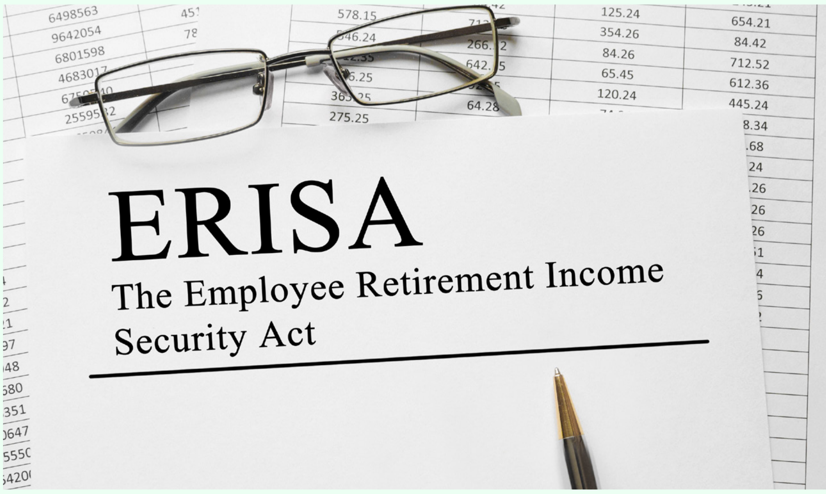


# Chapter 1: The United States and ERISA

## Introduction

The quest for clarity on pension funds corporate governance responsibilities and the utilization of private pension fund assets for broader social objectives began in the USA shortly after the enactment of comprehensive federal legislation creating a uniform national set of standards in the Employee Retirement Income Security Act (ERISA) in 1974. This established, *inter alia*, strict structural prohibitions against transactions among parties with specified relationships with the sponsors of pension funds and parties assigned investment authority in conjunction with broad prudence, exclusive purpose and diversification standards applicable to all deemed to exercise fiduciary responsibilities.

*An important objective of the Federal legislation was to establish a uniform set of requirements applicable to businesses providing benefits to workers located across a wide range of States.*




An important provision of the law, known as the "pre-emption" clause provides that the federal Law and associated regulations supersedes any State laws related to empl oyee benefit plans. ERISA's fiduciary standards are generally deemed to require investment decisions to be based solely on maximizing financial return and managing risks to achieve the greatest financial returns to provide benefits. This legal framework was, at the outset, generally construed to preclude consideration of other potential outcomes such as job creation (which was the primary concern at the time) formulating an investment strategy and making investment decisions. Prior to, and in the early years following enactment of the statute, managers of pension funds typically did not play any active role in the voting of proxies or other governance rights derived from their investments. They either did not engage in the process or simply deferred to the management of the companies, preferring to sell their shares when they perceived the results of votes to be disadvantageous to the value of the investment, what was sometimes referred to as "voting with their feet" by simply walking away.

## Economically targeted investments

In response to severe recession and high unemployment rates in the 1970's and 80's, various State and local pension funds (which remain outside of the fiduciary standards contained in ERISA though subject to closely related provisions of the tax code) undertook initiatives that were loosely described as economically targeted investments (ETIs). These sought to direct pension fund assets toward industries and initiatives that were expected to produce increased employment opportunities, often within areas most affected by loss of manufacturing and other industrial jobs resulting from what has become known as "globalization". In response to severe economic challenges in the 1970's and 80's a number of trade union affiliated (and in some cases jointly trusteed) plans sought to direct investment in a manner that would stimulate increased employment for their members. In the first Bush Administration (1989-1993), proposals that would direct pension fund investments into infrastructure financing were developed. Coming into office on the heels of one of the worst post war recessions and highest unemployment rates of the latter part of the 20th century, the Clinton Administration (1993-2001) aspired to free up what was perceived to be "workers capital" to achieve a virtuous cycle of job creation and investment returns.

In the early 1980's as private pension funds began to mature and the funding standards of ERISA took full effect, assets in private pension plans increased rapidly. At the same time the overall system began to shift toward defined contribution plans with the emergence of what are known as 401k type plans in which workers were permitted to defer a portion of their compensation into a tax preferred retirement savings account. The inherent need for DC plans to maximize long term yields and the overall increasing asset base made pension funds the largest institutional investors in US equity markets. This has led to an increasing appreciation of the potential role of pension funds in corporate governance.

## The Avon letter

In one of the more consequential early letters, the US Department of Labor (DOL) did significantly enhance perceptions regarding the affirmative requirement that pension funds exercise their corporate governance rights in what has become known as the "Avon letter" in 1988. This letter noted that governance rights and in particular the voting of proxies, by virtue of the ability to affect the potential value of an investment, had an economic value and therefore were an asset of the plan and subsumed within the same fiduciary standards that governed the management of all the plan's assets. The letter stated that "*the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock*". This interpretation facilitated the emergence of several advisory businesses that allowed plan managers to outsource the voting proxies in part to enable them to meet this obligation in a cost-effective manner. The requirement for pension funds to ensure that corporate governance rights were exercised was reinforced by a subsequent letter to one of these new entities, Institutional Shareholder Services (ISS), which stated that if the terms of the plan or a contract with an investment manager prohibited proxy voting, the responsibility remained with the plan's trustees to ensure that this aspect of managing the assets of the plans was addressed within the fiduciary standards of the law.

## Interpretive Bulletins: 1990s-2000

After some internal debate engendered by the advent of the Clinton Administration, in June of 1994 the DOL issued the first of a sequence of Interpretive Bulletins (IB 94-1) seeking to update and clarify ERISA's standards in relation to non-financial objectives in investment decisions and raising the form of guidance to a higher level than the earlier letters. This interpretation of the statute, (notably promulgated in a form that did not require the far more structured public notice and comment required of a "legislative regulation" and therefore afforded less deference by the courts but also far easier to subsequently modify) relaxed the perception of a simple prohibition by positing that secondary social and economic objectives were permissible to the extent that they allowed a fiduciary to select from among otherwise financially equivalent investment alternatives.

This interpretation was not an endorsement of investments in ETIs but rather somewhat of a double negative construction that effectively said that ERISA did not prevent such investments. It created what has become known as the "tie breaker" or "all things being equal" standard that allowed the inclusion of broader considerations but only to the extent they are collateral to the financial risk and return characteristics of the investment.

It required that the fiduciary engage in what would otherwise be construed to be a prudent and diligent analytical process to determine equivalence and that this process conclude that the investment was appropriate in consideration of all the other circumstances of the fund. Notably, and consistent with other similar pronouncements by DOL, the bulletin did not articulate any standard regarding what might constitute the necessary elements of the analysis required to reach these determinations.

Several weeks later, DOL issued a second Interpretive Bulletin (94-2) addressing the exercise of corporate governance rights associated with pension fund holdings, suggesting, at least by the timing, the conflation of the two sets of issues. This second bulletin reiterated the previous position that the voting of proxies and exercise of other rights of ownership was a duty of the responsible plan officials and must be undertaken within the established fiduciary framework of prudence and exclusive purpose. It embellished this view with the addition of commentary that, similar to ETI's, fiduciaries were not precluded from engaging in shareholder governance activities but with the admonition that this was appropriate only to the extent that such activities were likely to enhance the value of the pension funds' investment. Both pronouncements share the common attribute of neither endorsing nor prohibiting consideration of ancillary economic or governance considerations in the management of pension fund assets providing the fiduciary concluded, through a reasonable and complete analysis, that these were either immaterial to the financial value of the investment or had a reasonable likelihood of enhancing the financial performance.

The early 90's bulletins were generally perceived to have a very marginal impact on the investment patterns and exercise of corporate governance rights by pension funds. This was largely a consequence of the fact that they were primarily a reiteration of already well established and understood positions. They were understood to have a limited effect in removing some of the residual caution among fiduciaries in engaging in these activities.

## Interpretive Bulletins: 2000-2016

In October of 2008, the DOL issued two new Interpretive Bulletins, IB 2008-1 and IB 2008-2 that, similarly, addressed separately but in a coordinated manner the issues of ETI's and exercise of corporate governance rights. These explained that the new guidance was not intended to alter the previous interpretations but rather to further extend and explain their application. In the case of ETI's it did this by noting that circumstances were likely to be rare in which alternative investments would be equivalent and therefore subject to the "all things being equal" condition and that fiduciaries reaching this conclusion had an affirmative responsibility to undertake a rigorous analysis to reach this conclusion and to fully document their findings.

In regard to exercise of corporate governance the bulletin noted that plans should only engage in those activities where there is a determinable judgement that the exercise of proxy votes and other governance activities will affect the economic value of the investment and that the fiduciary must address the costs of exercising such rights in relation to the anticipated benefits. The bulletin notes that there are likely to be circumstances in which the costs outweigh the potential benefits and that the exclusive purpose requirement may be violated if "objectives, considerations and economic effects" unrelated to the plan's financial interest are considered in the exercise of governance rights.

These additions to the standards effectively shifted the burden of proof to the plan fiduciary to demonstrate the narrow consideration of factors and assess cost in relation to financial benefits. Ironically, and consistent with earlier and subsequent pronouncements on these issues, the DOL was not required to, and did not include, any cost-benefit or economic impact analysis to justify the decisions behind the guidance or its anticipated effects.

In 2015 and 2016 the DOL further opined on the subjects by issuing two more interpretations. These were justified with the observation that the 2008 guidance had "unduly discouraged fiduciaries from considering" certain types of investments and "worked to discourage" plan fiduciaries from exercising corporate governance rights. The new pronouncements withdrew the language of the 2008 guidance reinstating the 1995 language with some further elaborations. Interpretive Bulletin 2015-1, broadened the scope of the issues to now include environmental, social and governance (ESG) factors and extended the guidance with an important addition noting that ESG factors may be appropriately considered "not merely as tie-breakers" but as part of the "primary analysis of the economic merits of competing investment choices" and noting that fiduciaries need not "treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into account" ESG factors.

Interpretive Bulletin 2016-1 reverted to the language of the 1995 Bulletin on governance rights explicitly revoking the idea that cost benefit analysis and a "more likely than not" finding of a net positive financial benefit to the plan were conditions that needed to be met as a pre-requisite for shareholder activity by pension funds. This effectively reversed the burden of proof standard implicit in the 2008 guidance. It also noted that it was appropriate for plans to consider ESG issues in their exercise of voting rights, thus more explicitly linking the two sets of guidance and linking the broader concept of ESG issues to corporate governance activities. Although neither of the two IB's provided any evidence of the underlying presumption of the impact of the earlier bulletins, the 2016 guidance for the first time included some evidence of the prevalence of corporate governance and ESG issues in plan investment decisions as a justification for the need for the action.

Finally, in April of 2018 the DOL issued an even less formal type of interpretation in the form of a Field Assistance Bulleting (FAB) to provide guidance to its compliance enforcement staff in responding to questions on the application of the 2015 and 2016 bulletins. While ostensibly not revoking the earlier guidance, FAB 2018-1 seeks to dial back the potential engagement of plans with ESG issues by noting that fiduciaries must not "too readily treat ESG factors as economically relevant" and that "it does not ineluctably follow" that an investment that promotes ESG factors is a "prudent choice for retirement or other investors."

Likely the most consequential addition of the new guidance however is in distinguishing between the broader investment decisions of a plan and decisions regarding default investment funds in participant-directed individual account plans (most commonly 401k type plans). Here the most recent guidance notes that nothing in the separate regulation on default funds (funds in which a member's money is invested when they have not provided any other directions that are known as Qualified Default Investment Arrangements or QDIAs) suggests that it would be appropriate to select these "based on collateral public policy goals" and that a fiduciary selecting an ESG themed default investment without consideration of the potentially different and competing views of participants would "raise questions" about compliance with the basic concept of a duty of loyalty and exclusive purpose embodied in the statute. The guidance also notes, though somewhat obliquely, that the analysis of whether an ESG themed investment option will fulfill the "safe harbor" standard that shields a fiduciary from the consequences of plan participants directing their investments and which requires a minimum number of alternatives that meet certain criteria (what is known as the 404(c) regulation) is a different and distinct analysis than what is implied to be a lower standard for other investment decisions.

An important new development in the USA is the emergence of auto-enrollment type plans that operate at the State level. While these remain in a very nascent stage of development, some States have indicated that they will include ESG and responsible investing options in the choices available within these plans. While pension and retirement savings arrangements sponsored by State government for their own workers do not fall within the fiduciary standards of ERISA (the federal statue which preempts all state laws "related to" the provision of employee benefits) and are therefore not within DOL's jurisdiction, it is not clear the extent to which State sponsored plans covering private sector workers will be deemed to be plans within ERISA's ambit and therefore subject to DOL's interpretations. Initial guidance provided in 2015 by DOL suggested that if certain conditions are met that limit the involvement of employers to providing information and forwarding contributions to these arrangements, the State plans for private sector workers would not be deemed to be within the department's authority. This guidance however was pulled back by Congress and has not been subsequently replaced. This likely leaves many of these plans subject to whatever framework the individual State might impose.

In response to the perception that the interpretation of how ERISA's fiduciary standards apply to ESG and proxy voting issues was subject to differing interpretations under different administrations, and to bring some long-term consistency, a provision was included in a larger piece of pension legislation introduced in the Congress in 2017. The bill, entitled:

*the "Retirement Plan Simplification and Enhancement Act (REPSA)" would codify the 2015 Interpretive Bulletin by amending the statute to clarify that a fiduciary can take into account ESG factors to the extent that the fiduciary prudently determines that the investment is appropriate based solely on economic considerations, including those derived from such factors.*

This would take the interpretation out of the ambit of the DOL thereby requiring legislative action to alter it. It would also be afforded far greater deference by the courts. This legislative package is currently anticipated to be re-introduced into new Congress.

By virtue of the fact that the current interpretations are contained in various types of guidance that are neither legislative nor promulgated through the formal rule-making process, it remains uncertain the degree that the prevailing framework will be recognized in any compliance enforcement action either by the DOL or private parties. In significant part this will be affected by any case law or precedent. At present, however, there have been no enforcement cases brought by DOL or significant civil case law under ERISA that might provide any meaningful precedent.

## The current state of ESG requirements

Despite the seeming appearance of volleying back and forth the interpretation of the circumstances in which pension funds may appropriately include consideration of ESG factors reflecting the ideological predilections of successive administrations, the legal standards governing private employer pension fund investment have remained essentially constant over forty years. There remains no affirmative obligation for pension fund fiduciaries to explicitly consider ESG issues in their investment policies. In fact, there is no specific requirement for pension funds to be managed in relation to a written investment or risk management policy although doing so is certainly implicitly encouraged by the standards applied to investment decision making. Nor is there any requirement for engagement of plan beneficiaries in determining ESG related policies or any requirement for reporting on if or how this may be occurring. These are entirely left to the facts and circumstances relevant to each individual plan, consistent with the overall approach of ERISA.

ESG related investment decisions are clearly deemed to be permissible (or perhaps more accurately not prohibited) but explicitly relegated to a secondary consideration to the financial risk and return characteristics of the overall investment portfolio. If they are to be included, they are deemed to require the same prudent and thorough analysis of appropriateness and impact. There is a relatively clear prohibition against acceptance of lower return or increase in risk in the pursuit of collateral objectives. There are, however, no standards that have been articulated to guide a fiduciary electing to pursue ESG or ETI investments.

The general framework that has been put forth by the DOL remains in the form of secondary interpretations that do not have the same force of law or deference from the courts that standards contained in the statute or promulgated through what is known as "legislative rulemaking" that necessitates a much higher level of public scrutiny and would likely be deemed to require an accompanying economic impact analysis. It therefore remains unclear what effect the current standards will ultimately have which, absent further legislative or regulatory action will be determined by the precedent established by the Federal Courts.

*The statutory and regulatory framework that has emerged from four decades of incremental development imposes few clear standards on how ERISA covered pension funds may address ESG issues in the investment process or exercise the broader, though related, governance rights that may be associated with their investments.*

This affords wide discretion (and commensurate potential liability) for those making investment decisions for private pension funds. The door remains open for ESG factors to be considered and even to be included in the core evaluation of the long term economic and financial character of investment alternatives.

There is not, however, an affirmative requirement but rather a legal framework that says that consideration of these issues is not prohibited. If these issues are to be considered, to the extent that any standards have been articulated, they are largely hortatory in nature, requiring an analytical process without any clear requirements for what it must include. The development of the principles governing pension funds engagement with ESG issues, and any variations, has been largely in relation to subtle differences in where the burden of proof and default position lies, rather than any changes in the fundamental principle of reliance on "procedural prudence" or establishment of objective standards of analysis.

The exercise of corporate governance rights has for several decades been clearly deemed to be part of any investment management obligation of an ERISA covered plan. This is derived from the interpretation that governance rights have a financial value and potentially affect the future value of an investment. This, however, is not a sweeping obligation in which fiduciaries are required to actively engage in all corporate governance activities but rather an ownership right that must be exercised in consideration of the potential costs and value added, effectively subsuming these decisions within the more general fiduciary decision making standards. As with ESG related standards, there are currently scant guideposts that illuminate how a fiduciary might determine when this cost-benefit threshold is met leaving actual practices open to considerable latitude and associated risks.

# Chapter 2: Canada

## Introduction

In April of 2018, Canada's Minister of Environment and Climate Change and Minister of Finance jointly appointed an Expert Panel on Sustainable Finance. Its purpose was to explore opportunities and challenges facing Canada in this field, and to present the Government with a set of recommendations to scale and align sustainable finance in Canada with the country's climate and economic goals.[2] The panel's terms of reference included work with the private sector and the federal government to consider private-public leadership opportunities to advance sustainable finance opportunities in Canada, culminating in the preparation of a report outlining:[3]

- "Global trends in sustainable finance, including climate-related risk disclosure
- Roles and responsibilities for sustainable finance in Canada
- Opportunities and challenges relating to sustainable finance and climate-related risk disclosure in Canada
- Recommendations of potential next steps the Government of Canada may wish to consider within its area of jurisdiction."

The panel consulted with a variety of leaders and experts from academia, industry, government, and other organizations to produce an interim report in October of 2018. That report served as the basis for extensive additional research and discussions, including several roundtables, written submissions and bilateral consultations, culminating in the publication of their final report in June of 2019.

The Expert Panel final report includes 15 recommendations, including the ones reproduced below, which refer to topics discussed in this report.[4] Specifically:

- Recommendation 6: Clarify the scope of fiduciary duty in the context of climate change.
- Recommendation 5: Define and pursue a Canadian approach to implementing the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).
- Recommendation 9: Expand Canada's green fixed income market and set a global standard for transition-oriented financing.
- Recommendation 9.1: Convene key stakeholders to develop Canadian green and transition-oriented fixed income taxonomies.

## Fiduciary duty

At present, the regulatory landscape surrounding fiduciary obligations and sustainable investment within the Canadian pension industry remains relatively broad, however this is expected to shift in the near- to medium-term.

The legal standard of fiduciary obligation is long-standing in Canada, and is embedded within common, corporate, and financial services law.[5] Notably, in 2008, as a result of a legal challenge launched by bondholders of Bell Canada, the Supreme Court of Canada in *BCE Inc. v. 1976 Debentureholders*, held that:

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*"The fiduciary duty of the directors to the corporation is a broad, contextual concept. It is not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation."* [6]

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The *Canada Business Corporations Act* (CBCA) separates the duties into a duty of care and a duty of loyalty, or statutory fiduciary duty. The CBCA requires directors and officers exercise their powers and discharge duties "honestly and in good faith with a view to the best interests of the corporation" and to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[7] In 2019, the CBCA was amended to clarify factors that directors and officers may consider when acting with a view to the company's best interests, including the interests of shareholders, employees, pensioners, creditors, consumers and governments; the environment; and the long-term interests of the corporation.[8] This language confirms the range of considerations that directors can take into account in their oversight, and permits a more nuanced approach to the costs and benefits of particular actions.[9]

Additionally, effective as of 1 January 2020, as per *Section 172.1 (1)*, corporations governed by the CBCA with publicly traded securities, requires that: "The directors of a prescribed corporation shall place before the shareholders, at every annual meeting, the prescribed information respecting diversity among the directors and among the *members of senior management* as defined by regulation."[10] This includes the number and percentage of members of the board and of senior management who are women, Aboriginal persons, members of visible minorities and persons with disabilities.[11]

As of 2016, Section 78(3) of the *Ontario Pension Benefits Act* requires, with regard to environmental, social and governance (ESG) issues, "that a statement of investment policies and procedures include a statement about whether ESG factors are incorporated into the plan's investment policies and procedures, and if so, how they have been incorporated."[12] This does not constitute any requirement for plans to adopt a specific ESG program. However, in the circumstance that a plan does incorporate ESG factors into its investment policies, and asset managers are expected to comply with them, administrators have a fiduciary duty to ensure that the asset managers are in compliance with the incorporation of ESG factors.[13] The Ontario pension regulator, the Financial Services Regulatory Authority of Ontario (FSRA) supervises more than 1,300 pension plans covering over 4 million participants.

In January of 2021, the Office of the Superintendent of Financial Institutions (OSFI) released a consultation paper regarding climate-related risks and the financial sector[14] with respect to its oversight of federally regulated financial institutions (FRFIs) and federally regulated pension plans (FRPPs). The paper notes that while "OSFI's current guidance does not reference climate-related risks specifically,

it includes principles and expectations that are relevant to FRFI's (FRPPs) management of these risks."

Additionally, during 2021, OSFI worked with the Bank of Canada and a number of key Canadian FIs on a pilot project to help the Canadian financial sector assess climate change risks. The project used climate-change scenario analysis to provide a better understanding of the risks to the financial system with respect to a transition towards a low-carbon economy. The report was released in January 2022, with some of the highlights noted below:[15]

- All scenarios showed that this transition will entail important risks for some economic sectors. Mispricing of transition risks could expose financial institutions and investors to sudden and large losses. It could also delay investments needed to help mitigate the impact of climate change.
- The scenarios also deliberately focus on transition risks rather than physical risks. This is an area for future work.
- Scenario analysis is a better tool to use for this work than traditional economic models because climate change is global and complex, and the risks involved have very long-time horizons. Further, there is a large amount of uncertainty about how emerging technologies and policies will evolve to address climate change.

- In the future, it will be important to work toward better data collection on exposures and vulnerabilities and for more institutions to employ scenario analysis. Future work could consider, for example, physical risks related to climate change, other types of risk, or larger systemic considerations.

There are over 16,000 registered pension plans in Canada. By early 2021, the assets of the top eight totaled approximately CAD$2 trillion (US$1.65 trillion), with the top three accounting for more than half of that amount. The Canadian Coalition for Good Governance (CCGG), whose members collectively manage CAD$4.5 trillion, includes seven of eight leading Canadian pensions. Principle 7 of the CCGG's Stewardship Principles states that: "Institutional investors should make sure they understand the risks and opportunities associated with material sustainability factors, including ESG issues, and integrate them into their investment and stewardship activities."

In response to Canada's Expert Panel on Sustainable Finance recommendation 6, Sarra and Williams, both Canadian members of the Commonwealth Climate and Law Initiative, published a 2019 report that included recommendations with respect to fiduciary obligation and disclosure.[16] With respect to fiduciary duty, the authors recommend:

- Amend the Canada Business Corporations Act, the Bank Act and the Insurance Companies Act to embed ESG factors, including climate-related risks and opportunities, in the fiduciary obligation of directors and officers.
- Require institutional investors and asset managers, including pension funds and mutual funds, to disclose how their portfolio management, voting and engagement activities are contributing to a lower carbon economy.

In June of 2020, Hansell LLP published an important legal opinion indicating that Canadian directors are obligated to consider climate change risks and opportunities relevant to the companies of which they sit on the board. The analysis iterates the need for directors to ensure that, where material, management must develop strategies to address both climate change risks and opportunities.

A failure to do so could facilitate legal liability, not dissimilar to any other kind of risk.[17] Both the Saskatchewan and Ontario Courts of Appeal have held that human-caused climate change poses an existential threat.[18] Given these appellate court findings, directors and officers can no longer plausibly argue that they are unaware of the serious threat of climate-related legal risks to their companies.[19]

*A May 2021 legal opinion from Randy Bauslaugh of McCarthy Tétrault LLP concludes that climate change considerations lie squarely under the fiduciary responsibilities of pension plans.*

Notably, the report arrives at this conclusion based on interpretation of current law and based on an acceptance of the fact that climate change is a material financial consideration. In fact, the opinion does not really spend much time debating whether the consideration of climate change is the right thing to do for pensions from a social or moral perspective, stating:

"The bottom-line is that their management focus must be on value, not values, and that climate change affects value."[20]

Four of the largest eight pension plans in Canada are members of the Climate Action 100+ and all support the TCFD. The three largest pension plans in Canada as of 31 December 2021 (i.e., Canada Pension Plan Investment Board (CAD$550.4 billion); Caisse de depot et placement du Quebec (CAD $419.8B); and Ontario Teachers' Pension Plan (CAD$241.6 billion)) have committed to net-zero emissions portfolios by 2050, including plans to work with their portfolio companies to also achieve net-zero by 2050.

From the investing industry perspective, there are currently over 200 Canadian asset owners and managers who are UN-PRI signatories. A 2020 report from Canada's Responsible Investment Association shows that CAD$3.2 trillion in assets were managed in alignment with a "responsible" investment strategy by the end of 2019, more than six times the 2006 figure of CAD$459.5 billion. The report notes that this represents 61.8% of Canada's investment industry, up from 50.6% two years prior.[21] At the institutional level, RBC's 2020 Responsible Investment Survey of over 800 global investors showed that among the Canadians included in this survey:[22]

- 87% believe that integrating ESG factors can help mitigate risk
- 70% believe ESG-integrated portfolios help generate long-term sustainable alpha and,
- 63% integrated ESG factors because they believed it was a component of their fiduciary duty.

## ESG and climate-related disclosures

Canadian reporting issuers are required to disclose material risks associated with climate change in their periodic disclosure as per requirements set out in *Staff Notice 51-333 Environmental Reporting Guidance*, issued by the Canadian Securities Administrators (CSA).[23] In August 2019, the CSA followed up with the issuance of *Staff Notice 51-358 Reporting of Climate Change-related Risks* to assist companies in identifying and improving their disclosure of material risks posed by climate change.[24] The notice clarifies existing legal requirements, while reinforcing and expanding upon the guidance provided in the previous notice. This notice encourages issuers to disclose material information relating to climate change-related risks in Annual Information Forms (AIF) and the Management Discussion and Analysis (MD&A).[25] They are also required to disclose in certain instances such as Item 5.1(1)(k) of Form 51-102F2, which requires disclosure of financial and operational effects of environmental protection requirements in the current financial year and expected effect in future years.

*Specifically, the CSA has stated: "Climate change related risks are a mainstream business issue. Issuers should consider these risks as part of their ongoing risk management and disclosure processes, and they must disclose any such risks that are material to their business."* [26]

The guidance states, "despite the potential uncertainties and longer time horizon associated with climate change-related risks, boards and management should take appropriate steps to understand and assess the materiality of these risks to their business. Boards are to consider a broad spectrum of potential climate change-related risks over the short-, medium- and long-term."[27]

The Government of Canada publicly endorsed the recommendations of the Financial Stability Board's TCFD in 2019 and supports the "voluntary international disclosure standards and a phased approach to adopting them by major Canadian companies, as appropriate."[28] In a signal of this support, during 2020, the government required TCFD disclosures as a condition for companies applying to receive emergency COVID-19 funding.[29]

In January 2021, the Ontario Capital Markets Modernization Taskforce released a recommendation report, which includes the suggestion to mandate the disclosure of material ESG information, specifically climate change-related disclosure that reflects the recommendations of the TCFD for issuers through regulatory filing requirements of the OSC.[30] The report recommends that these reporting requirements be phased in over a period of two years for large issuers, three years for medium-sized issuers, and five years for smaller issuers. Of note is that the recommendations exclude the requirement for scenario analysis that is recommended by TCFD. In October of 2021, the CSA issued a consultation paper requesting feedback on recommendations that included a phased in approach to adopting a significant portion of the TCFD recommendations (although also notably excluding the scenario analysis requirement).[31]

The 2019 Sarra and Williams report referenced above provided the following recommendations with respect to climate-related financial disclosures:[32]

- Embed ESG matters in financial statements and enhance corporate disclosure on ESG, including climate-related financial risk, in reporting requirements of publicly listed companies.
- Endorse the TCFD disclosure framework and work with accounting standards setters and securities authorities to align climate-related financial disclosure.

On 25 November 2020, the CEOs of eight leading Canadian pension plan investment managers, representing approximately CAD$1.6 trillion of assets under management, issued a rare joint statement expressing support for companies and investors to provide "consistent and complete" ESG information to "strengthen investment decision-making and better assess and manage their collective ESG risk exposures."[33] The statement further iterates that the pension plans "believe companies demonstrating ESG-astute practices and disclosure will outperform over the long-term" and that the pension plans they manage will "allocate capital to investments best placed to deliver long-term sustainable value creation."[34] In June 2021, the 10 largest Canadian pensions made a similar statement in response to an SEC request for input.

According to Milani, as of 2020, 71% of S&P/TSX Composite Index issuers prepared dedicated ESG reports, versus 58% in 2019 and only 36% in 2016.[35] That same report indicates that as of 2020, 56% of S&P/TSX Composite Index issuers reported in alignment with the SASB guidelines, up from 36% in 2019, and only 6% during 2018. The report further notes that 42% of Index issuers reported in alignment with the TCFD recommendations, up from 30% in 2019. By August of 2021, there were 94 Canadian TCFD Supporters, including 49 financial institutions.

## Green and transition financing and defining a taxonomy for Canada

During 2021, Canadian green bond issuance was US$10.0 billion, up from US$8.5 billion in 2020 and just US$537 million in 2016. This ranked Canada eighth globally during 2021. The Province of Ontario was the first Canadian entity to issue a green bond in 2014, raising CAD$3.05 billion to fund transit and energy efficiency projects.[36] In 2018, the Canada Pension Plan Investment Board (CPPIB) became the world's first pension fund to enter the green bond market, with a placement worth CAD$1.5 billion.[37]

The Canadian federal government took an important step toward mainstreaming sustainable practices in Canadian financial markets with the decision to issue its first-ever green bond in 2021-22.[38] The announcement signaled to the financial sector that Canada is serious about an investment tool that will be a cornerstone of the country's effort to speed up greenhouse gas reductions and achieve net-zero emissions by 2050. Within Budget 2021, the federal government announced an issuance target of CAD$5 billion, and in March 2022, they published their Green Bond Framework.[39]

In support of the pursuit towards enhanced clarity for Canadian investors around whether companies are allocating capital to address climate-related risks and opportunities, the Canadian Standards Association (CSA Group) established a Transition Taxonomy Technical Committee (TTTC), responsible for developing a Sustainable Finance-Defining Green Taxonomy for Canada.

This initiative comes out of the recognition that many Canadian sectors are at risk of being excluded from Green and Transition financial products and services, such as Green Bonds and Green Loans.[40] Most green taxonomies developed around the world do not recognize several Canadian natural-resource sectors as being "Green" or "In Transition." The TTTC is currently developing "Express Document CSAR1200," which will form the framework for both a Canadian specific standard, and for Canada's participation in formulating a new ISO Sustainable Finance Standard.[41] This report is expected to be released in 2022.

# Chapter 3: The European Union and the IORP framework

The development and approach toward pension funds in the EU are, in many respects, a mirror image of the USA. In contrast to a uniform Federal law that preempts State laws in the USA, the EU approach begins with deference to existing laws at the member state (or national) level and then seeks to achieve a degree of "harmonization" by establishing a broad EU wide set of standards that individual countries are encouraged to fulfill but with provision of considerable latitude to reflect their own particular structure of pension regulation and policy objectives. There remains, however, considerable tension in the implementation of the EU wide standards and how member state variations are accommodated.

At the end of 2019, the European Commission presented the European Green Deal, the most ambitious package of measures that should enable Europe to become the world's first climate-neutral continent by 2050. Reaching this target will require action by all sectors of our economy. The European Union is strongly supporting the transition to a low-carbon, more resource-efficient and sustainable economy and it has been at the forefront of efforts to build a financial system that supports sustainable growth. Based on the Commission's action plan on sustainable finance (2018), the European Union is currently examining how to integrate sustainability considerations into its financial policy framework in order to mobilize finance for sustainable growth and adopted several new legislations that will completely reshape the rules of the games in the financial markets: the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR).

The aim of this chapter is to give a comprehensive overview of the development of sustainable finance provisions in Europe. To that aim, the evolution of the debates and legislative acts is addressed at both the national and EU level. Having in mind the particular difficulty of providing a detailed picture of the historical development of sustainable finance provisions all over Europe, we have focused on several national case studies together with the EU level discussions. The chapter is organized as follows: section 1 gives a brief analysis of the 'prudent person rule' at the EU level, starting with the adoption of the first IORP Directive and reaching up the most recent developments in EU legislative process that aim to steer the fiduciary duty towards the incorporation of explicit green investment duties. Section 2 analyses the legislative frameworks of a few EU member states, with the aim of describing recent milestones in regard to ESG policies and sustainable finance.

# Section 1: Developments at the EU level

## The prudent person rule in EU legislation

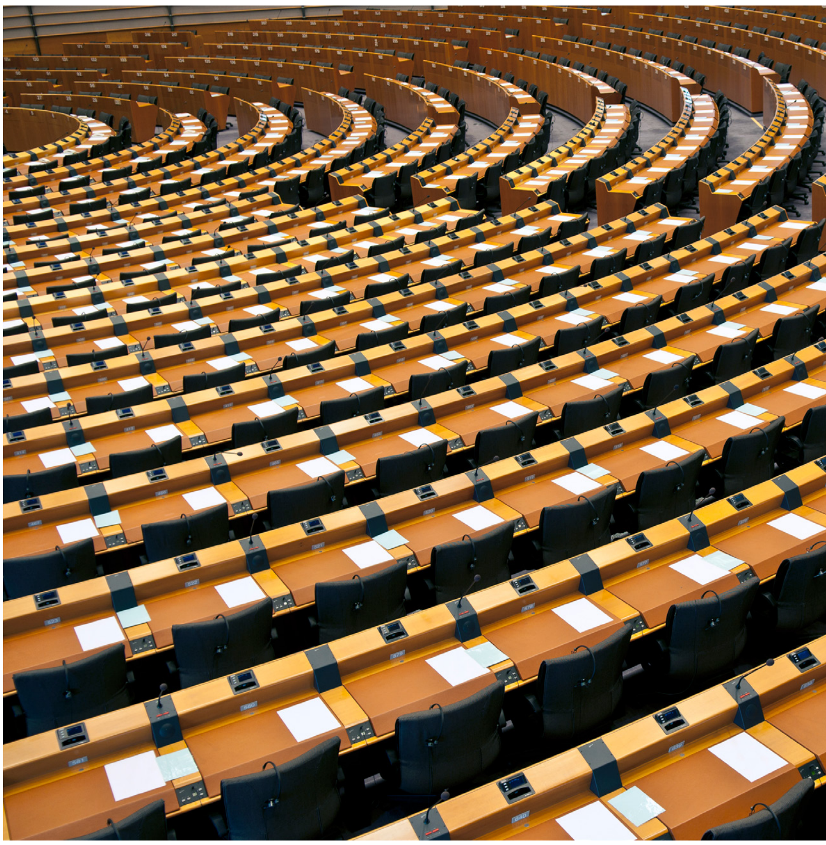
The term 'sustainable investment' has emerged only recently in the policy-making discussions at the EU level, indicating that public debates have been increasingly focused on climate change mitigation and environmental goals. Instead, shifting finance and investment towards sustainable goals (also) in regard to pension funds has been implicitly linked with the 'prudent person rule' (PPR), which refers to certain obligations for institutional investors that must be taken into consideration when investing. In that regard, the definition and interpretation of the PPR has important consequences on the way asset managers decide to allocate their assets, as part of a long-term investment strategy[42].

The first attempt at EU level to regulate the activities and supervision of occupational pension funds was the European Union's Directive 2003/41/EC (also known as IORP Directive). Among other issues, these rules aimed at making the 'prudent person rule' the underlying principle for capital investment[43]. According to the Directive, an institution for occupational retirement provision or IOPR "means an institution, irrespective of its legal form, operating on a funded basis, established separately from any sponsoring undertaking or trade for the purpose of providing retirement benefits in the context of an occupational activity on the basis of an agreement or a contract agreed:

a) individually or collectively between the employer(s) and the employee(s) or their respective representatives, or

b) with self-employed persons, in compliance with the legislation of the home and host Member States"[44].

The PPR refers to a principle, thus allowing for substantial flexibility and a wide margin of freedom in regard to the investors' investment policies. Importantly, the Directive explicitly stipulates that only national institutions (and not EU ones, which are supra-national) can require from IORPs to invest according to the PPR, thus showing that compliance takes into consideration an investment policy appropriate to the "membership structure" and specific national context of each IORP[45]. Article 18 paragraph 1 describes in more detail the principle:



Member States shall require institutions located in their territories to invest in accordance with the 'prudent person' rule and in particular in accordance with the following rules:

**a)** *the assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or the entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries;*

*b) the assets shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the expected future retirement benefits;*

*c) the assets shall be predominantly invested on regulated markets. Investment in assets which are not admitted to trading on a regulated financial market must in any event be kept to prudent levels;*

*d) investment in derivative instruments shall be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the institution's assets. The institution shall also avoid excessive risk exposure to a single counterparty and to other derivative operations;*

*e) the assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the institution to excessive risk concentration;*

*f) investment in the sponsoring undertaking shall be no more than 5 % of the portfolio as a whole and, when the sponsoring undertaking belongs to a group, investment in the undertakings belonging to the same group as the sponsoring undertaking shall not be more than 10 % of the portfolio.*

When the institution is sponsored by a number of undertakings, investment in these sponsoring undertakings shall be made prudently, taking into account the need for proper diversification.

Member States may decide not to apply the requirements referred to in points (e) and (f) to investment in vgovernment bonds.

It is clear that the IOPR Directive of 2003 did not explicitly incorporate environmental, social or governance (ESG) factors in its investment rules, but rather focused on the security and profitability of investments as well as on the representability of the interests of members and beneficiaries. To that goal, it mentions asset diversification and mitigation of risk exposure, but does not specifically show a particular orientation for green investing.

## IORP II Directive [Directive (EU) 2016/2341]

In 2014, the European Parliament amended the European Commission's proposal on the revision of the IORP Directive, in order to improve the governance, risk management and cross-border activity of occupational pensions funds as well as to increase transparency and enhance information requirements to members. The European Commission and the Council accepted many of those proposals. After years of discussions with the industry stakeholders and negotiations among EU institutions, the reviewed directive, known as IORP II, came into effect on 12 January 2017, leaving two years to national governments to transpose it into national law[46].

The prudent person rule was included in the updated Directive, while being enhanced with the introduction of ESG factors. In particular, article 19 paragraph 1 (b) stipulates:

> *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;*

Recital 58 of the Directive is indicative of the importance given to ESG factors and the legislative text does not restrict the incorporation of ESG factors in the Prudent Person Rule and investment rules but instead adopts a wide approach covering multiple aspects regarding the functioning of an occupational pension fund.

This refers to:

> **General governance requirements (Article 22, par. 1):**
> *"The system of governance shall include consideration of environmental, social and governance factors related to investment assets in investment decisions and shall be subject to regular internal review".*
>
> **Own-risk assessment[47] (Article 28, par. 2):**
> *"Member States shall ensure that the risk assessment [...] includes the following:*
> *h) where environmental, social and governance factors are considered in investment decisions, an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change".*
>
> **Statement of investment policy principles[48] (Article 30):**
> *"Member States shall provide for this statement to contain, at least, such matters as the 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".*

# Information to be given to prospective members (Article 41, par. 1 and 3)

**Information to be given to prospective members (Article 41, par. 1 and 3):**
*"1. Member States shall require IORPs to ensure that prospective members who are not automatically enrolled in a pension scheme are informed, before they join that pension scheme, about:*
*(c) information on whether and how environmental, climate, social and corporate governance factors are considered in the investment approach".*
*"3. Member States shall require IORPs to ensure that prospective members who are automatically enrolled in a pension scheme are promptly after their enrolment, informed about:*
*(c) information on whether and how environmental, climate, social and corporate governance factors are considered in the investment approach".*

In July 2021, in the text of the EU renewed sustainable finance strategy communication, European Commission plans to ask EIOPA to assess by 2022 the need to review fiduciary duties to reflect inside-out ESG risks including stewardship and the potential need to broaden the concept of the "long-term best interest of members and beneficiaries"

## The European framework on sustainable finance

Incentivized to a great degree by the recent international developments for the promotion of environmental goals, such as the UN 2030 Agenda for Sustainable Development, the Sustainable Development Goals and the Paris Climate Agreement, the European Commission or EC (which is the executive body of the European Union) created in December 2016 a High-Level Expert Group on Sustainable Finance (HLEG), comprising of 20 representatives of the finance sector, academia, civil society and EU institutions, in order to provide their expertise on how to define and promote risks related to the environment, among other issues.

After HLEG published its interim and final reports in July 2017 and January 2018 respectively, the European Commission adopted in March 2018 its action plan on sustainable finance, with the aim of streamlining ESG factors in its financial policy and at the same time increasing financing for the development of a European 'Capital Markets Union'[49].

*At the end of 2019, the European Commission presented the European Green Deal, the most ambitious package of measures that should enable Europe to become the world's first climate-neutral continent by 2050. Reaching this target will require action by all sectors of our economy.*

In the meantime, the European Union is examining how to integrate sustainability considerations into its financial policy framework in order to mobilize finance for sustainable growth and adopted two major Regulations that will reshape the rules of the game in the financial markets: the Sustainability Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation.

## Corporate sustainable reporting directive

The objective of the proposed CSRD is to improve sustainability reporting to better exploit the potential of the European single market and to contribute to the transition to a fully sustainable and inclusive economic and financial system in line with the European Green Deal and the UN Sustainable Development Goals.

The key proposals include a massive broadening of scope of the NFRD from 11,600 to approximately 49,000 entities in the EU including foreign subsidiaries. Companies coming under the CSRD would be:

- all companies listed on a regulated EU market (with the exception of micro entities), and
- large companies that are not listed on a regulated EU market; large companies are defined as companies that exceed at least two of the following three size criteria at the balance sheet date:
  - Balance sheet total: EUR 20,000,000
  - Net revenue: EUR 40,000,000
  - Average number of employees during the financial year: 250.

The EC proposes a transposition of the CSRD into national law by member states by 1 December 2022, so that the amendments would be applicable for the first time for fiscal years beginning on or after 1 January 2023.

## Taxonomy regulation

The Taxonomy Regulation provides for a general framework that will allow for the progressive development of an EU-wide classification system for environmentally sustainable economic activities. All financial products that make the claim that they contribute to environmental sustainability will have to prove this by disclosing the share of their investments into activities that are considered sustainable. Notably, the Regulation sets out the following six environmental objectives:

- Climate change mitigation
- Climate change adaptation
- Sustainable use and porotection of water and marine resources
- Transition to a circular economy
- Pollution prevention and control
- Protection and restoration of biodiversity and ecosystems

Four requirements that economic activities need to comply with in order to qualify:

- They provide a substantial contribution to at least one of the six environmental objectives above
- “No significant harm” is caused to any of the other environmental objectives
- Compliance with robust and science-based technical screening criteria and
- Compliance with minimum social and governance safeguards.

The screening criteria and the thresholds to be considered in order to define the situations where an economic activity can be considered as contributing to a sustainable objective are being developed by the Commission with the support of a balanced platform of experts. Corporates will have to disclose their alignment with the Taxonomy. A game-changer in terms of tackling climate change, the ESG Taxonomy will be the basis for future developments on sustainable finance.

## Sustainable Finance Disclosures Regulation

At the end of 2019, the Sustainable Finance Disclosures Regulation (SFDR) has been adopted and published in the Official Journal of the European Union. SFDR sets out new requirements for all financial market participants (FMPs) to disclose information on how their processes and investment decisions take account of sustainability-related risks, opportunities and impacts, and mandates the three European Supervisory Authorities (ESAs: EIOPA, ESMA and EBA) to develop draft Regulatory Technical Standards (RTS) to define the content, methodologies and presentation of the new disclosures. Under SFDR, it is notable that all financial market participants with more than 500 employees will have to disclose information on the principal adverse impact of their investment decisions on ESG factors and screen their aggregate investments against a large set of indicators that will be defined in the ESAs' draft RTS (e.g.: carbon emissions; carbon footprint, biodiversity and ecosystem preservation practices; non-recycle waste ratio, Board gender diversity, human right policy, excessive CEO pay ratio). Furthermore, SFDR also aims to mitigate the risk of greenwashing and when a pension plan or any other financial product is marketed as promoting ESG characteristics or as pursuing a specific sustainability objective, SFDR requires extensive pre-contractual and periodic disclosures, including a description and monitoring of the promoted ESG characteristics or sustainable investment objectives as well as information on the selected sustainability indicators. The new disclosure requirements will have to be implemented by March 2021.

On 22 October 2021, the final report on Taxonomy- related Product disclosure RTS level 2 was published. The ESAs' finalised draft RTS1 (the 'SFDR RTS'), which were published 4 February 2021, have already established the content, methodology and presentation of other disclosures to be made under the SFDR in accordance with the ESAs' empowerments. The ESAs' aim now is to have the technical standards on disclosures rules function as a "single rulebook" for sustainability disclosures for both the original empowerments in the SFDR and the additional ones added by the Taxonomy. Level two RTS officially should be implemented by January 2023.

## Other initiatives and next steps

EU authorities agreed to amend the Benchmarks Regulation and introduced rules establishing and governing the provision of low carbon and positive carbon impact benchmarks. Harmonised rules for low carbon benchmarks should lead to more efficient channeling of investment towards sustainable assets.

Even if the design of the general framework has been agreed, some important legislative developments are still being discussed. As previously mentioned, the ESAs are finalising their draft disclosure RTS that will define the content of the ESG information to be disclosed, the indicators to identify adverse sustainability impacts and the information to be included in pre-contractual disclosures under SFDR. The European Commission is also expected to release soon its proposal for the review of the Non-Financial Reporting Directive (NFRD) which should ensure that all investors have access to adequate non-financial information from investee companies to comply with the new ESG disclosure requirements.

*In July 2021, the European Commission published its renewed sustainable Finance Strategy Communication (the Strategy).*

The Strategy sets out how it will support the EU Green Deal and Europe's transition to becoming a carbon neutral continent by 2050. This will be achieved through:

- Financing the transition to sustainability and expanding coverage of the EU taxonomy.
- Building in inclusiveness with greater support for SMEs and individuals to access sustainable finance and participate in building a sustainable economy.
- Tackling the financial sector's resilience to sustainability risks and supporting its contribution.
- Playing a more active role in global institutional infrastructure of sustainable finance.

In the strategy, the Commission also describes some future initiatives such as the potential extension of the EU Taxonomy to social objectives (Social Taxonomy- preliminary draft report was published in July) and the potential adoption of a Brown Taxonomy, the establishment of a common EU ESG database, as well as other issues related to sustainability ratings, ESG accounting standards (EFRAG will publish the new standards by mid-2022), EU green bonds, benchmarks and potential actions to mitigate short termism.

More importantly and in view of the review of the IORP II Directive planned in 2023, the new action plan may consider the introduction of new amendments to further improve the integration of members' and beneficiaries' ESG preferences in the investment strategies and the management and governance of IORPs as well as other considerations to improve ESG integration and reporting beyond what is currently required by the regulatory framework.

## The development of an EU social taxonomy as part of sustainable finance

As mentioned earlier, together with the environmental aspects of sustainable finance, the EU aims to take into consideration also the social side. On 12 July 2021 the EU Platform on Sustainable Finance, which is an advisory group of the European Commission, published its draft report on the creation of a social taxonomy, as part of the broader work of the Platform and EU institutions to establish a taxonomy framework for defining and categorizing sustainable economic activities. The EU Platform's subgroup 4 is charged with the task to advise the Commission on extending the taxonomy to social objectives and compliance with minimum social safeguards.

Following an open stakeholder consultation call, the EU Platform on Sustainable Finance prepared its draft final version set to be published by the end of 2021. The draft report argues that in the light of the COVID-19 pandemic, but also given the social aspects of a sustainable transition, it is important to identify economic activities that contribute to advancing social objectives.

The final draft report is aligned with international norms and principles like the sustainable development goals (SDG) and the UN guiding principles for businesses and human rights but also with EU initiatives such as the European Pillar of Social Rights (EPSR). The draft report argues that a social taxonomy would help investors to identify opportunities to finance solutions around ensuring decent work, enabling inclusive and sustainable communities and affordable healthcare and housing.

The main task of the social taxonomy subgroup of the EU Platform for Sustainable Finance is to suggest a structure for a social taxonomy, and in particular:

- What constitutes a substantial social contribution?
- How to not do significant harm?
- What activities are harmful?

Similar to the environmental taxonomy the suggested structure of a social taxonomy consists of three objectives:

1. Decent work (including value chain workers)

   This objective would include sub-objectives that emphasise key aspects of respecting and supporting human rights in terms of impacts on affected workers, including on core labour rights. It would also reflect employment generation for certain groups of people as it also relates to the 'just transition'.

2. Adequate living standards and wellbeing for end users

   This objective emphasises key aspects of respecting and supporting the human rights of end users, including health risks of end users and accessibility of products and services for basic human needs

3. Inclusive and sustainable communities and societies.

This objective will emphasise key aspects of respecting and supporting human rights in terms of impacts on communities and the wider society by reducing negative impact and making basic economic infrastructure available to certain target groups.

On 28 February 2022, the European Commission's Platform on Sustainable Finance published the final Report on EU Social Taxonomy.[50] For the time being, Social and Governance factors are mentioned in the more advanced EU environmental taxonomy framework, as part of minimum social safeguards. The social taxonomy aims at identifying credible approaches to mitigate social and human right violations by companies by providing guidance to capital market participants and helping them to recognize sustainable investments.

According to the report, the EU Social Taxonomy could have some elements in common with the current environmental taxonomy and:

- Develop social objectives
- Adopt a substantial contribution principle
- Rely on the Do Not Significantly Harm (DNSH) criteria
- Include minimum safeguards.

## EC Proposal on the corporate sustainability due diligence

On 23 February 2022, the European Commission presented its proposal on the corporate sustainability due diligence.

*The proposal aims to foster sustainable and responsible corporate behaviour throughout global value chains.*

They will be required to identify and, where necessary, prevent, end or mitigate adverse impacts of their activities on human rights, such as child labour and exploitation of workers, and on the environment, for example pollution and biodiversity loss. This proposal establishes a corporate sustainability due diligence duty to address negative human rights and environmental impacts. IORPs are included in the definition of the company in the proposal's text.

The new due diligence rules will apply to the following companies and sectors:

- EU companies:
  - Group 1: all EU limited liability companies of substantial size and economic power (with 500+ employees and EUR 150 million+ in net turnover worldwide).
  - Group 2: Other limited liability companies operating in defined high impact sectors, which do not meet both Group 1 thresholds, but have more than 250 employees and a net turnover of EUR 40 million worldwide and more. For these companies, rules will start to apply 2 years later than for Group 1.
  - Non-EU companies active in the EU with turnover threshold aligned with Group 1 and 2, generated in the EU.

Small and medium enterprises (SMEs) are not directly in the scope of this proposal.

This proposal applies to the company's own operations, their subsidiaries and their value chains (direct and indirect established business relationships). In order to comply with the corporate due diligence duty, companies need to:

- Integrate due diligence into policies
- Identify actual or potential adverse human rights and environmental impacts
- Prevent or mitigate potential impacts
- End or minimise actual impacts
- Establish and maintain a complaints procedure
- Monitor the effectiveness of the due diligence policy and measures and
- Publicly communicate on due diligence

National administrative authorities appointed by Member States will be responsible for supervising these new rules and may impose fines in case of non-compliance. In addition, victims will have the opportunity to take legal action for damages that could have been avoided with appropriate due diligence measures.

## Next steps

The proposal will be presented to the European Parliament and the Council for approval. Once adopted, Member States will have two years to transpose the Directive into national law and communicate the relevant texts to the Commission.

# Section 2: Developments at national level

## National case studies

### Netherlands

The civil law legal system in the Netherlands sets out the requirements relating to the fiduciary duty in statutory law, rather than case law. The social partners play a strong role in the governance of pension funds, with representatives of both the employer and employees in the Board. In this model, there is a stronger link between the members and their representatives compared to the UK, where the trustees should act in the interest of members but ultimately without taking their views on board.

*The relevant statutory provisions are part of the Pension Fund Code. Owing to the paritarian nature of the system, the Code is set by the Dutch Federation of Pensions and the social partners, but legally binding.*

The Code specifies in more detail the requirements set out in the Dutch Pension Law and ultimately IORP II and follows a 'comply or explain' principle. It requires Pension Funds to create support amongst the membership on sustainable investment practices through representative bodies and stakeholder bodies. The Board of a pension fund should disclose its responsible investment principles to the membership and stakeholders. As a consequence, some pension funds have representative bodies with a specific mandate to provide views to the Board on sustainable investment practices. There are also pension funds that survey members on their views on sustainable investments. There are also some legal requirements relating to exclusions, notably in the case of cluster ammunition. Financial institutions established in the Netherlands should refrain from investing or lending to companies that produce these weapons.

In 2018 the Dutch pension sector have set-up a sustainable investment covenant in cooperation with the NGO sector, trade unions and Dutch government. Under this agreement, the 73 signatory funds representing the lion share of Dutch pension assets, aim to prevent or tackle negative consequences for society and the environment of investments by pension funds. The agreement follows an approach based on the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights (UNGPs) to identify, prioritise and address such ESG risks. By identifying risks relating to investments made by the pension funds, the funds should gain a better understanding of where risks of e.g., human rights abuses or environmental damage occur. On this basis, they should be able to exert their influence to solve problems and reduce risks, with the help of the knowledge and experience of the other parties to the agreement and their local partners. Pension funds are expected to make a sound assessment of risks and to adjust their policies and practices where necessary in the light of these risks. In addition, the pension funds that specifically sign-up work together with-the other stakeholders on cases in order to develop solutions to abuses that occur in the investment chain of pension funds. Following the baseline measurement, an independent Monitoring Committee will monitor once a year the progress made by the parties in carrying out the agreed activities.

## Sweden

*The Swedish pension system is divided into three pillars: the national public pension, an occupational pension and a possible private pension.*

The national public pension system is partly PAYG and partly funded. There exist a number of national pension funds (or buffer funds) to manage the funded part (AP1, AP2, AP3, AP4, AP7), which are in principle public entities. The occupational pension system is governed through collective agreements between unions and employers. As of 1.1.2022, many Pension Funds are modifying their legal form, and they are becoming IORPs.

In 2000 a new law on pension funds was introduced, where the funds were required to take ethical and environmental considerations into account in their investment choices. This ethical and environmental clause is, however, subordinated to the primary objective of high return, in line with the understanding of fiduciary duty in other parts of Europe. This was the first mandate in the law on the AP funds to into account environmental and ethical considerations in the investment process. The law did not define how environmental and ethical considerations were to be defined. As a result, the Swedish buffer funds established diverging approaches to their responsible investment practices. Occupational funds, although not legally obliged, followed in the buffer funds footsteps and voluntarily established responsible investment policies.

Swedish funds were pioneers in the field of sustainable investments. Although environmental and ethical considerations were not defined in the law, the buffer funds aimed to align their policies with the broader values of the Swedish society. They also became strong supporters of international initiatives, such as UNPRI and the OECD's Principles of Corporate Governance and Guidelines for Multinational Enterprises. Exclusionary policies became widespread amongst both buffer funds and occupational funds. More recently, some of the buffer funds have also included views on stranded assets in their ESG policies, but not all. In late 2018, the Swedish parliament voted that the country's buffer funds should be 'exemplary' in regard to ESG factors, nevertheless not providing for an explicit definition. As a result, a working group was set up with the aim to develop and eventually implement a set of ESG-related expectations[51].

## France

France has been one of the first EU member states to adopt provisions regulating the functioning of financial institutions in regard to sustainable investment, leading the way for other countries.

The 2015 'energy transition for green growth law' -better known as 'Energy Transition Law'- sets out an ambitious framework for the reduction of greenhouse gas emissions and the decrease of energy consumption based on non-renewable sources of energy, such as fossil fuels and nuclear power.

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*Art. 173 par. 3 of the Energy Transition Law has been a novelty at a global level, introducing the mandatory requirement for institutional investors to disclose in their annual report how their activities promote environmental goals.*

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The latter group (including actors such as banks, insurance companies, asset managers and pension funds that vary in size and legal form) have to indicate:

- How they take into consideration ESG criteria in regard to their investment decisions.
- How they align their policies with the French national strategy referring to environmental and energy transition strategy

The obligations set up by art. 173 par. 3 were further clarified through an implementation decree (No. 2015-1850 of 29 December 2015), stipulating that disclosures provisions would start in 2017[51]. The guidelines established in the decree draw a relatively flexible reporting landscape, meaning that investors can choose on how to disclose the carbon footprint of their portfolio, while providing additional information on their estimation methodology according to the principle of 'comply or explain'. This means that in the case of non-conformity, a justification must be provided. Importantly, the decree applies the principle of proportionality, according to which small institutional investors are obliged to provide only a general overview of their disclosure method.

France has also been very active in promoting global coordination on environmental goals and sustainable finance, hosting the 2015 United Nations' Climate Change Conference -also known as COP 21- which received widespread attention all over the world. In a symbolical gesture from a political and policy-making point of view, the French President Francois Hollande was the first to sign the UN Paris Agreement on 22 April 2016. The Paris Agreement was an important milestone which showed the collective will of many state actors at the global level to tackle the issue of climate change. Along with limiting the rise of global temperature (art. 2.1a) and increasing the states' ability to adapt to climate impacts (art. 2.1b), the Agreement aimed at "making finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development" (art. 2.1C).

Since the 2015 Energy Transition Law came into place, France has followed concrete steps to achieve a smooth, timely and efficient energy transition. With the aim of investing 1.5% of yearly GDP in green and sustainable projects, France has started to actively redirect finance into low-carbon investments[53]. In particular, the French government set out a 'Big Investment Plan' with a total worth of €57 billion, with a five-year horizon[54]. To that goal, the country has adopted a higher national carbon tax, and issued €9.7 billion worth of sovereign green bonds in 2017, ranking 3rd in the record year of global bond issuance (after the US and China). In 2019, France became the leading issuer of green bonds in the world, overtaking the US and the Netherlands[55].

## Germany

Germany has embarked on a journey to develop the country "into a leading center for sustainable finance."

*To pursue this objective, the German Federal Government appointed in June 2019 the "Sustainable Finance Committee"*

for the time up until the next federal elections (due in September 2021) in order to "pool existing expertise and promote dialogue between the relevant actors".[56] It brings together practitioners from the financial and real economy, civil society and academia. The Interim Report of the Committee was published at the beginning of March 2020 and consulted after that.[57]

Taking this consultation into account, the Final Report Shifting the Trillions – A sustainable financial system for the great transformation was published in February 2021.[58] It contains 31 recommendations on "how the transformation of the German economy can be financed with a sustainable financial system." They focus on five main areas:

1. A reliable national and European policy framework that lays a coherent groundwork for promoting sustainability in the financial sector and real economy
2. Integrated and forward-looking company reporting that ensures transparency and comparability, which in turn provide a basis for sustainable investment decisions and comprehensive risk management
3. Research and systematic knowledge-building with a particular focus on the changing skills and expertise that are needed among the people who are responsible for regulation, for the management and supervision of companies, for providing financial consulting services, and in the public sphere in general

4. Sustainable financial products that satisfy growing investor demand

5. Consolidating sustainable finance by building up institutional capacities that can provide continuous monitoring and guidance during the transformation process."

Particularly relevant for occupational pensions are Recommendation 4 on the Supervisory Regime for IORPs, Recommendation 22 on the Promotion of Sustainable Products and Recommendation 31 on Institutional Investor Engagement. The German Government is reviewing these recommendations carefully and it is expected that they will shape German sustainable finance policy over the next years. The take up of the recommendations will depend on the outcome of the election in September 2021 and the new government.

Already in force since December 2019 is the Guidance Notice on Dealing with Sustainability Risks by the German supervisor BaFin (the Bundesbank also contributed).[59] An official translation into English is available since January 2020.[60] The Guidance Notice is addressed to all entities (i.a. IORPs) supervised by the BaFin and provides suggestions and recommendations on dealing with sustainability risks. The BaFin expects that all entities look at the relevant risks and document that they have done so. The Guidance Notice does not (yet) prescribe methodologies but leaves it up to the supervised entities to choose them. It already includes requirements from the EU Sustainable Finance Disclosure Regulation (2019/2088, consolidated version).[61]

In addition, there are initiatives by the industry, such as the voluntary commitment by the German financial sector from June 2020 (Klimaschutz Selbstverpflichtung des Finanzsektors).[62] Initially, 16 actors covering €5.5 trillion committed themselves to measuring and reducing the impact of their portfolios on the climate and to foster the transition of the economy.

## The United Kingdom

The English, Welsh and Northern Irish legal systems are based in the common law tradition and as such, the framework for responsible investments has been influenced heavily by case law and the trustee's legal obligation under English law.

Traditionally, common law stipulated those fiduciaries should act in the best interest of the member, which was to be solely understood as best financial interests. This gave fiduciaries very little leeway to incorporate non-financial factors in investment decision-making in the UK. This started to change when courts ruled that non-financial considerations were allowed to be the tiebreaker between two investments with the same risk-return profile. This principle was not very useful in practical terms as it is not likely potential investments will have *exactly* the same results. Trustees were still concerned about the extent to which ESG investments were compliant with their fiduciary duties. However, it did indicate that the thinking around ESG was starting to shift, and courts also did allow pension funds to divest from parts of the market on ethical groups, notably the Church of England pension fund. Thinking subsequently evolved to argue that ESG factors can be financially material and therefore compliant with the fiduciary duty. In 2018, the Department of Work stated it would amend statutory rules which supplement the case law so that pension schemes should have a policy on how they consider financially material factors such as environmental, social, and governance factors, including climate change. This is intended to remove lingering confusion over trustee's duties to consider ESG factors. Climate change, as an ESG issue, has been deliberately drawn out to focus minds on its 'systemic and cross cutting nature'.

There remains a debate, however, about non-financial factors, even though guidance by the Law Commission in 2014 stated that

> *"the law is flexible enough to accommodate other concerns. Trustees may take account of non-financial factors if they have a good reason to think that the scheme members share a particular view, and their decision does not risk significant financial detriment to the fund".*

Case law was supplemented by further guidance and regulation. Since 2000, pension funds in the UK are required to disclose their policy on ESG issues as part of their statement of investment principles. In 2010 the Financial Reporting Council released the UK Stewardship Code, with principles that institutional investors are expected to follow. The Code, which follows a comply-or-explain approach, sets out principles for disclosure, monitoring of investee companies, voting policies, etcetera.

# Chapter 4: Australia

Superannuation in Australia is generally compulsory and is further encouraged by tax benefits. It is compulsory for employers to make superannuation contributions (in addition to an employee's salary or wage). Most people can choose which superannuation fund they would like their contributions paid into, although most superannuation fund members are automatically defaulted into a fund through the industrial relations system (e.g., some industrial awards specify a fund or a choice of a few funds). The employer contribution rate has been 10% of ordinary earnings from 2021. The contribution rate is planned to increase gradually (0.5% each year) to 12% in 2025. Additional voluntary contributions are encouraged with tax incentives, subject to certain caps. Withdrawal of funds by beneficiaries is regulated, with individuals unable to withdraw their funds except in certain circumstances (such as retirement, illness, incapacitation).

Superannuation assets in Australia totaled AUD$3.44 trillion at the end of March 2022. Superannuation funds operate as trusts, with trustees responsible for the prudential operation of their funds in formulation and implementing an investment strategy. The *Superannuation Industry (Supervision) Act 1993* (SIS Act) codifies some specific duties and obligations.

*In addition, general trust law operates. The SIS Act requires trustees to perform their duties and powers in the best financial interests of beneficiaries.[63]*

The SIS Act also provides that the prudential regulator, the Australian Prudential Regulation Authority (APRA) may determine standards relating to prudential matters that must be complied with by funds[64]. APRA publishes standards and practice guidance for superannuation fund trustees.

APRA Practice Guide *SPG 530 – Investment Governance*[65] highlights that the SIS Act[66] requires a Registrable Superannuation Entity (RSE) to consider the risk and likely return from investments, diversification, liquidity, valuation and other relevant factors. It identifies that where it does not conflict with the requirements of the Act, RSEs are permitted to consider additional factors to act in the best interests of beneficiaries.[67]

SPG 530 currently provides that 'ethical investing' could be one of the additional factors that an RSE licensee may consider (where it does not conflict with the requirements of the SIS Act). According to APRA's guidance, 'ethical investment' is '*typically characterised by an added focus on environmental, sustainability, social and governance considerations, or integrates such considerations into the formulation of the investment strategy and supporting analysis*.'

On 22 April 2021, APRA released Prudential Practice Guide *CPG 229 - Climate Change Financial Risks* (CPG 229). It is designed to assist APRA-regulated entities in managing climate-related risks and opportunities as part of their existing risk management and governance frameworks.

APRA has developed CPG 229 in response to requests from industry for greater clarity of regulatory expectations and examples of better industry practice. The guidance covers APRA's view of sound practice in areas such as governance, risk management, scenario analysis and disclosure.

The Australian Council of Superannuation Investors[68] (ACSI) and the UN Principles for Responsible Investment (PRI) have recently argued that APRA's SPG 530 confuses two different concepts, being ethical investing and ESG integration.

In particular, ethical investing attempts to balance the desire for returns with an investor's values by excluding investments that are inconsistent with those values (for example, excluding investments in tobacco, firearms or gambling). ESG integration on the other hand takes a different approach, based on the premise that investments will perform better over the long term when ESG risks and opportunities are appropriately managed. Therefore, the management of ESG risks and opportunities can be material to long-term returns.

ACSI has also argued that superannuation fund trustee boards should be required to have access to both capacity and competence on ESG issues.

In April 2019, APRA released its *Information Paper: Review of APRA's 2013 superannuation prudential framework* which identified potential areas of its standards and guidance for future enhancement. One of the areas identified for enhancement is to review and update the guidance on consideration of ESG factors in formulating investment strategy. In particular, it is expected that APRA will consult on the following revisions:

- SPS/SPG 530 – Investment Governance
  - Clarifying or strengthening the factors that RSE licensees are required to consider for member directed (choice) investment options,
  - Considering additional guidance or requirements to enhance the application of investment strategy stress testing,
  - Reviewing and updating the guidance on consideration of ESG factors in formulating investment strategy.

- SPS/SPG 510 – Governance. Strengthening the nomination, appointment and removal process of RSE licensees particularly in relation to:
  - Skills and experience of boards; this could be achieved by requiring RSE licensees to have a skills matrix in place, with additional guidance to be provided on the formulation of this matrix and its key elements
  - Composition of boards needs to be considered holistically to ensure the board continues to remain appropriate for its membership base into the future; this could be achieved by limiting board tenure to a specified period and other enhancements to board renewal processes and
  - Board performance assessment processes could be more robust and address the board's performance in a range of areas, including delivery of member outcomes and strategy execution; APRA could provide feedback on industry best practice in relation to board performance assessment processes.

Accordingly, it is reasonable to expect that the Australian prudential regulatory regime will be updated in the near term. An update to better reflect ESG integration would be consistent with the atmosphere in Australia, where ESG related risk has recently been the subject of significant discussion following the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. In that Report, in the context of a director's duty to act in the best interests of a corporation, Justice Hayne stated:

> *The longer the period of reference, the more likely it is that the interests of shareholders, customers, employees and all associated with any corporation will be seen as converging on the corporation's continued long-term financial advantage.*

And long-term financial advantage will more likely follow if the entity conducts its business according to proper standards, treats its employees well and seeks to provide financial results to shareholders that, in the long run, are better than other investments of broadly similar risk.[69]

More explicit recognition of the importance of ESG integration would also be consistent with APRA's recent statements on climate change in its *Information Paper Climate Change: Awareness to action* released in March 2019 – in particular that:

*...while the implications of a changing climate will have a long-term impact and the time horizon for the risks can be uncertain, this does not justify inaction.*

There is a high degree of certainty that financial risks will materialise, and entities can mitigate the magnitude of the impacts of these risks through action in the short term. Entities can also seek a competitive advantage through their preparation for the transition to a low-carbon economy. Similarly, APRA has noted that it is imprudent for entities or regulators to ignore such risks just because there is uncertainty, or even controversy, about the policy outlook. With these factors in mind, APRA continues to encourage regulated entities to con sider climate risks within their risk management frameworks, consistent with APRA's risk management prudential standards[70].

In July 2019 a group of Australian financial system participants (more than 140 participants from over 80 organisations across Australia's financial system, including financial institutions, civil society, academia, regulators and government) formed the Australian Sustainable Finance Initiative to set the roadmap for Australia's financial system's contribution to a national agenda for global competitiveness while prioritizing sustainable growth for a long-term prosperous economy.

ASFI released the Australian Sustainable Finance Roadmap[71] (the Roadmap) in November 2020. It is a plan to connect capital to a sustainable and prosperous Australia. The Roadmap acknowledges the environmental and climate risks Australia faces through extreme weather events like drought, floods and fires; the impact of the COVID-19 pandemic and rising economic inequality in Australian society.

The Roadmap outlines a plan to transform Australia's financial system into one that is better-prepared to face future risks and shocks such as a changing climate. It can also meet the current needs of Australians while delivering on long-term needs for a sustainable future; can enhance the financial inclusion and well-being of all Australians, including our most vulnerable; and can direct capital to where it is most needed in delivering a transition to a net zero, resource-efficient and inclusive economy.

This means focusing on where capital is lent, what can be insured and where money is invested.

*The key aim is to support and build value today while strengthening the economic, natural and social assets that underpin our long-term prosperity.*

While governments across Australia – federal, state and local – are setting a direction for a stronger and more sustainable nation, the Roadmap is the Australian financial system's contribution to ensuring finance is mobilised and connected to a sustainable future where all Australians can feel confident.

Australian Governments are directing investment in a manner consistent with our contribution to international conventions and frameworks, such as the Paris Agreement, Sustainable Development Goals, Sendai Framework, Convention on Biological Diversity and the United Nations Guiding Principles on Business and Human Rights. To achieve these goals there needs to be an alignment with the financial services sector.

The Roadmap's vision for Australia is a financial system:

- that is sustainable, resilient and stable, and can manage systemic risks and other shocks and strains
- that meets both the present and long-term needs of all Australians, the environment and the economy
- where financial decisions are informed and consider sustainability risks, impacts and opportunities
- that enhances financial inclusion and well-being, and informed choice and
- where capital flows support Australia in delivering on sustainable development goals, including facilitating an orderly transition to a net zero emissions, resource-efficient and socially inclusive economy.[72]

The Roadmap makes 37 recommendations and includes an Action Plan with short (2021-2022), medium (2023-2025) and long-term (2026-2030) timeframes. To align Australia's financial system to support this vision will require financial system participants to:

1. Provide support to deliver the Sustainable Development Goals (SDGs) and Australia's commitments to the Paris Agreement, Sendai Framework for Disaster Risk Reduction and Convention on Biological Diversity,

2. Support the transition of the Australian economy to net zero emissions by 2050,

3. Embed sustainability into leadership, purpose, strategy, risk management and practice of financial institutions,

4. Enable the financial system to facilitate change by developing and implementing collaborative practices across the whole of the financial system, including government, regulators, financial institutions, households and communities.[73]

On 21 May 2022, Australia held its federal election, the results of which transitioned in a new Government formed by the Australian Labor Party (ALP). As a part of its election platform, the ALP has promised greater policy considerations on climate change. Over the next three years, Australia will monitor the progress of ESG initiatives in the context of a new Parliament.

# Chapter 5: Latin America

## Executive summary

- A Socially Responsible Investment (SRI) is an investment that considers both traditional financial criteria (risk-return), and extra-financial criteria in the analysis and investment decision-making processes. These extra-financial criteria are the ESG factors. These factors can materialize adversely, with collateral effects for returns on investments.
- The materiality of ESG factors is currently understood as a reality by several renowned international agencies.

*Incorporating ESG factors in the investment analysis of social security resources would appear to be essential for achieving enhanced performance and risk balance.*

- According to the United Nations, integrating ESG factors into investment analysis, contributes to the purpose of fiduciary responsibility.[74]
- The key question is how to integrate these factors into investment processes. There are several SRI strategies in practice: exclusion due to behavior contrary to international standards and basic rights; exclusion of activities (e.g., arms manufacture); assessment of outstanding traits (Best-in-Class), through the selection of companies that have greater ESG ratings once financial analysis has been conducted.
- The Chilean, Colombian, Spanish, Mexican and Brazilian private pension funds are advancing in the self-regulation of the application of SRI concepts and ESG factors in investment decision-making.
- In addition to being excellent fund managers, seeking the best risk-return combinations, the AFPs must not lose sight of the fact that the returns of the markets in which they operate may also be affected by extra financial risks associated with ESG factors in the long term. Due to their importance for the risk-performance balance, it is perhaps time for the rest of the Latin American countries to advance further in these matters.

There has been growing interest in integrating ESG factors into the analysis of social security resources investment. The main argument is that such factors can materialize adversely, with undesired collateral effects for returns on investments. Hence, these factors should be considered, at least in the field of self-regulation. This brief document defines what is understood by "responsible investment" and its relationship to ESG factors, explaining why these concepts should be considered in the analysis of social security resources investment, giving Spain and Colombia as examples.

I. Socially Responsible Investment, Environmental, Social and Corporate Governance factors and their relevance for institutional investors.

An SRI is an investment that considers traditional financial criteria (risk-return) and extra-financial criteria in the investment analysis and decision-making processes, as well as the exercising of political rights inherent to certain financial assets.

The aforementioned extra-financial criteria are the ESG. These factors are long-term systemic aspects that contribute to the sustainability of companies and their ability to generate value. In the short term, these factors can materialize adversely, with undesired collateral effects for returns on investments.

According to Borremans[75], companies are facing increasingly more disruptive challenges, that can be divided into four major areas: (i) financial pressure; (ii) governance concerns; (iii) social challenges; and (iv) environmental limits (see Table 1). These challenges are related to pressure from investors and financial markets to achieve short-term rather than long-term results. ESG factors can cause damage and can be lethal for institutional investors, which is why they must be duly considered when investing in companies.

### Table 1. Companies face disruptive challenges

| | |
|---|---|
| Financial pressures | Short-terminism<br>Over-dependency on leverage |
| Governance concerns | Market abuse<br>principal-agent issues<br>Accounting creativity and tax avoidance |
| Social challanges | Product health & safety concerns<br>Poor labour standards<br>Human rights violations |
| Enviromental limits | Depletion of natural resources<br>Enviromental degradation<br>Climate change |

Source: Borremans (2016). [76]

According to Sustainalytics, a leading company worldwide in research on responsible investment and the practical implementation of ESG factors for investment decision-making, expanding the information horizon with which investment decisions are taken, and incorporating ESG factors in those analyses, would appear to be essential for enhancing performance and risk balance. The materiality of ESG factors is currently understood as a reality by the US Securities and Exchange Commission (SEC), the Institute of Chartered Financial Analysts (CFA), McKinsey and Co., and the Harvard Business Review, among others. The question is no longer "Do ESG factors impact financial performance or not?" but rather "How can ESG factors be integrated into the investment processes of institutional investors, in order to avoid or minimize their negative impacts?"

The market recognizes the materiality of ESG factors. This is reflected in the strong acceptance by countries and many companies, of the Principles for Responsible Investment of the United Nations (PRI). There are currently 1,500 affiliated members (signatories) to such principles, representing assets close to US$62 trillion.

The Global Sustainable Investment Alliance (GSIA), also points out that about US$13.6 trillion in assets are managed under some ESG factor (Latin America is not considered in the study), representing 21.8% of globally managed assets. Europe, the USA and Canada account for 96% of investments involving ESG factors. Given the above, it is perhaps time for Latin America to further advance in these matters.

The fiduciary responsibility of institutional investors is related to materiality. According to the United Nations, integrating ESG factors in the investment analysis for achieving enhanced financial performance forecasts, is clearly permissible and contributes to the purpose of fiduciary responsibility.[76] Eccles (2016)[77] emphasizes that if pension funds have a long-term outlook for their beneficiaries, they would be ignoring their fiduciary duty by not considering ESG aspects in investment decision-making.

II. SRI in practice: selection and management of the different types of assets that are part of the SRI products

The identification of eligible assets for an SRI product is based on a combination of two complementary analyses:

1. Extra-financial analysis: Consists in identifying and assessing the good ESG practices of companies:

    » Knowledge of key issues in each sector of activity (for example, the customer-supplier relationship in wholesale trade; environmental protection policies; best CG practices; decent working conditions in production/distribution chains, etc.).

    » Assessment within each sector of activity of the companies that best meet the ESG criteria, through regular meetings with them.

2. Financial analysis: To determine and assess the most attractive companies from a financial standpoint.

From this dual assessment, the product manager buys or sells shares, bonds or company debt to build the SRI products.

There are different SRI strategies that can be applied within products. The most common are:

- Exclusion due to behavior contrary to international standards and basic rights.
- Exclusion of activities (for example, controversial arms).
- Assessment of outstanding traits (Best-in-Class), through the selection of companies with enhanced ESG assessment after financial analysis.
- Dialogue with companies (aimed at improving the ESG performance of companies through processes of dialogue).
- Integration of ESG criteria in traditional financial analysis. Consists in the assessment of investment portfolios, explicitly including ESG considerations in traditional financial analysis.
- ESG thematic investments. This is a form of direct integration that consists in selecting companies and investments related to sustainable development issues and sectors, such as renewable energy, water, health, agriculture and forestry, or more generally climate change and eco-efficiency, among others.

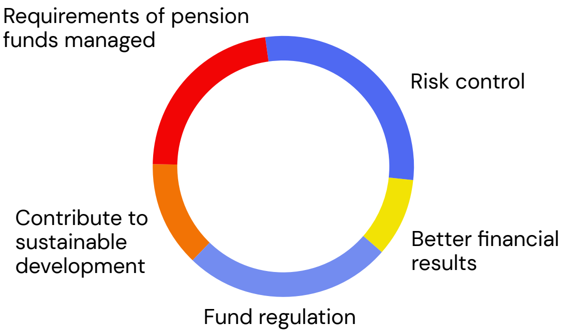
## The Spanish private pension funds

Among the Pension Funds of the FIAP member countries, the Spanish private voluntary pension funds[78] are perhaps the ones that most apply responsible investment policies and ESG factors in their investment strategies. As is apparent from a NOVASTER (2016) publication,[79] the pension funds sector in the country has evolved significantly in the last year, in line with European trends.

Most of the Pension Fund Managers analyzed in the report, that manage assets of €71,957 million (approx. US$77,345 million) and account for 69% of the sector, have personnel specializing in ESG, and 4 have subscribed to the Responsible Investment Principles of the United Nations (RIP).

Regarding the motivations for considering ESG issues (see Graph 1), all the fund managers understand that these factors are useful for controlling long-term risk. A second motivation is the protection of the reputation of the entity. Third is the requirement to apply ESG issues by the pension funds they manage. Fourth is contributing to sustainable development. Finally, there is the pursuit of better financial results.

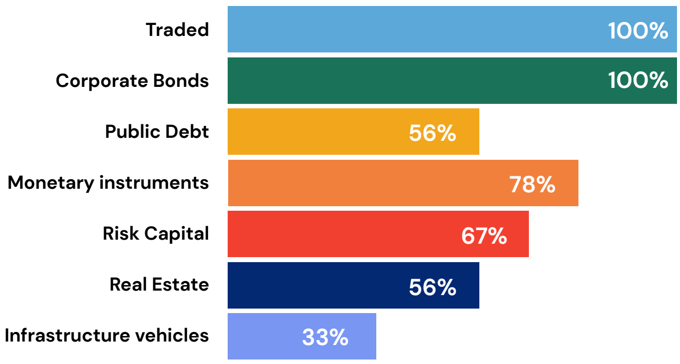
### Graph 1: Motivations for considering ESG issues




Source: NOVASTER 2016.[80]

All the fund managers have formalized an ESG policy, which evidences the degree of development and maturity of the industry in this area. All the fund managers also apply their ESG policies to their stock market investments, and virtually all of them apply them to corporate bonds or will do so in future. A majority of fund managers apply it, or will do so, to monetary assets (treasury bills, corporate promissory notes, etc), risk capital, public debt and real estate. They apply it to infrastructure in only three cases, mostly because four funds do not invest in these types of assets (see Graph 2).

### Graph 2: Current or planned application of ESG factors per asset classes




Source: NOVASTER, 2016.

All fund managers say that they perform some kind of integration in their SRI investment strategies. Five fund managers apply some kind of Best-in-Class. Two of them make thematic investments. Six of them apply pure integration, in which ESG issues are considered in financial and investment decisions, whereas two of them practice combined integration with some degree of exclusion.

## The AFPs in Latin America

On reviewing the websites, annual reports and investment policies of the Latin American AFPs, it was found that there is an incipient degree of self-regulation in the industry with respect to the incorporation of ESG in decision-making regarding the investment of pension resources. The leading countries in this regard are Chile, Colombia, Mexico and Peru.

A brief review of each experience is given below:

## Chile

Only one of the AFPs in the market (AFP Cuprum) has explicitly supported SRI to date.

AFP Cuprum has had a sustainability strategy in place for several years now, with Responsible Management of Investments as one of its key pillars, incorporating ESG criteria in its investments and risk control.

According to the company, any investment analysis would be incomplete without an in-depth study of the company's governance, the possible environmental and social impact of its operations and how it relates to the community, since these elements can be decisive in the long-term returns of the investment. Hence, and as a token of its commitment to ongoing integration of ESG factors in its investment processes, AFP Cuprum has adhered to the PRIs as of January 1, 2019.

## Colombia

There are three AFPs that explicitly refer to SRI:

- AFP Horizonte: Following the Principle of Responsible Investment, it developed a complement to its policy for measuring the adoption of Country Code and CG practices by securities issuers in the Colombian market, which aims to extend the assessment framework to the social and environmental spheres. The implementation of these two areas was carried out through the formulation of eleven questions based on what was considered standard practice among securities issuers in the Colombian market, and they were added to the results of eighty questions of the Financial Superintendency's survey.

  The result obtained was a percentage for each issuer that determines a criterion for the allocation of its credit limit. The issuers in which these policies will be evaluated are part of the real and financial sectors of the Colombian market, and they must complete the Country Code Survey and have a line of credit with AFP Horizonte.

- AFP Old Mutual: Among its discretional policies for assessing the CG of issuers, it states that a securities issuer must be an investment recipient, and among other criteria, must: (i) adopt rules, standards, codes of conduct or international initiatives related to ESG factors; (ii) publish reports to shareholders and/or the securities market related to ESG factors ; (iii) include in their annual reports explanations and the evolution of ESG aspects in the company; (iv) support the initiatives and resolutions of the shareholders that promote the dissemination of ESG principles.
- AFP Protección: Its investment policies state that it may invest in all sectors except those related to pornography, gambling or the manufacture of arms or ammunition used in wars or military conflicts. Additionally, the AFP incorporates social and environmental considerations in investment decision-making processes in those alternatives which, due to their nature, represent any kind of impact and/or risk to the environment and society.

## Mexico

Environmental issues opened up the SRI debate in this country. The Climate Finance Advisory Board (CCFC) was created in November 2016. It is co-chaired by the Retirement Fund Manager (Afore) Citibanamx and Sura. The Board's purpose is to promote the financing of projects that contribute to mitigation and adaptation to climate change among institutional investors, through green bond market incentives.

The Board comprises high-level representatives of the Mexican financial sector, including: Afores, Insurance Companies, Associations, Commercial Banks, Development and Multilateral Banks, Issuers, Investment Funds Managers and other institutions. The Board is sponsored by the Bolsa Mexicana de Valores Group and the *Climate Bonds Initiative*, a leading global organization in boosting the green bond market.

Last December 14, 2018, the CCFV and the Green Financing Initiative of the City of London, signed a green financing collaboration agreement, aimed at strengthening cooperation and the exchange of knowledge between the two initiatives. Due to this agreement, 51 institutional investors, who collectively manage MXN 4.52 billion (approx. USD 231 million) in assets, signed a declaration calling for the disclosure of ESG information in Mexico. In this document, Afores, insurance companies, investment fund managers, investment advisors and development banks acknowledged that ESG information constitutes an important source of information for investment analysis and the efficient allocation of resources. They also acknowledged that the disclosure of ESG data must be expanded, calling for improving the generation of information and its correct use in investment processes by the signatories.

Subsequently, on June 5, 2017, International Environment Day, the Afores reaffirmed their commitment to sustainable and equitable development for the benefit of workers and for increasing their pensions.

## Peru

The Responsible Investment Program has been in place in this country since 2014. It emerged within the framework of the COP20 in Lima, through the financial sector's leadership in contributing to the country's sustainable development. The institutions promoting this initiative were the Lima Stock Exchange, Grupo SURA, A2G and COFIDE.

This Program seeks to change the investment culture by articulating and empowering the key players of the financial sector, promoting responsible investment policies and practices and the integration of the ESG variables for developing a more competitive and attractive business environment, and thereby contributing to the long-term sustainable development of the country.

Several organizations have been part of this program to date, including 3 AFPs: AFP Integra, AFP Prima, and AFP Profuturo.

Prima AFP also adhered to the PRIs as of January 31, 2019.

## Proposals and challenges for the AFPs

According to Enrione (2016), there are three proposals on how the AFPs can and must influence the quality and performance of CG in the markets in which they operate:

- **Rigorously examine their own practices.** In order to demand improvements in the CG standards of the companies in which they invest, they must first conduct a critical self-examination. For example: Does the local market see the AFPs as examples of good CG practices? Do the AFPs comply with the same criteria that they impose or preach in the companies in which they invest? Do they really believe that their Boards of Directors are significantly better than the market average? Do the AFP processes consider the needs of their clients?

- **Explore a universal property** perspective. It is clear that the pension funds have a sole line of business, but given the huge amounts of the managed funds, the degrees of diversification and the long-term investment horizons, one should seriously consider the concept of "universal property." This means that the long-term value of investments will depend on country risk, the social fabric, the quality of institutions, human capital and environmental performance. Hence, the AFPs, beyond being excellent fund managers in search of the best risk-return combinations, must not lose sight of the fact that in the long term, the returns of the markets in which they operate can also be affected by these risks.

- **That investment is perceived as a force for good.** If the AFPs, which are the largest economic investment force in the region, set high standards, at least for a portion of the local portfolio and international investments, then they must meet and disseminate these standards. Developing and disseminating local market and ESG factor rankings, and strengthening their communication areas, would appear to be key in this matter.

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