European Pension Authority Issues Opinion on ESG Pension Investing

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The revised Institution for Occupational Retirement Provision Directive issued by the European Union ("EU") in 2016, known as IORP II, requires IORPs (i.e., pension funds in the EU) to take into consideration environmental, social and governance (ESG) factors and risks in investing their funds. The EU's quasi-regulatory agency for pensions, the European Insurance and Occupational Pensions Authority ("EIOPA") has now issued an opinion to country regulators on how ESG factors should be taken into account. This is in addition to EU Directives that already require IORPs to publicly disclose how they integrate shareholder engagement in their investment strategy and its implementation.

Those charged with global governance of pension plans and pension investment in multinational companies may wish to watch this development closely, as the EU may influence pension investing trends in other countries. The UK has already begun to require that Statements of Investment Principles for both DB and DC plans must address ESG considerations beginning in October, 2019. And ESG investing is a hot topic for US pension plans, for example.

Defining E, S and G

Notably, the opinion sets forth definitions for E, S and G:

> Environmental (E): Issues relating to the quality and functioning of the natural environment and natural systems. These include: biodiversity loss, greenhouse gas (GHG) emissions, climate change, renewable energy, energy efficiency, air, water or resource depletion or pollution, waste management, stratospheric ozone depletion, change in land use, ocean acidification and changes to the nitrogen and phosphorus cycles.
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> Social (S): Issues relating to the rights, well-being and interests of people and communities. These include: human rights, labour standards in the supply chain, child, slave and bonded labour, workplace health and safety, freedom of association and freedom of expression, human capital management and employee relations; diversity; relations with local communities,

activities in conflict zones, health and access to medicine, HIV/AIDS, consumer protection; and controversial weapons.

Governance (G): Issues relating to the governance of companies and other investee entities. In the listed equity context these include: board structure, size, diversity, skills and independence, executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls and risk management, and, in general, issues dealing with the relationship between a company's management, its board, its shareholders and its stakeholders. This category may also include matters of business strategy, encompassing both the implications of business strategy for environmental and social issues, and how the strategy is to be implemented. In the unlisted asset classes governance issues also include matters of fund governance, such as the powers of Advisory Committees, valuation issues, fee structures, etc.

These definitions are based on the United Nations Principles for Responsible Investment (UNPRI).

The opinion goes on to state that competent regulatory authorities "should use a range of supervisory techniques to assess IORP's management of ESG risks, like reviewing the ESG risk management documents and reports and challenging the IORP on its ESG risk management policy during conversation with its management."

Further, such supervisory authorities "should expect more direct quantifications of risk exposures by means of scenario analysis with respect to climate change and, in particular, the possible transition paths to a low-carbon economy, being an area where advances have been made."

The supervisory authorities "should encourage IORPs to publicly disclose a description of their management of ESG risks, in a transparent and comprehensible manner that allows members and beneficiaries, sponsors, other stakeholders and the public to assess the approach taken."

However, the opinion also notes that "ESG risk assessment and management is still maturing", and that a market risk is that "[c]ompanies/sectors invest in new low carbon technologies, some of which may not prove to be successful."

Reaction from Private Sector Representatives in the EU

PensionsEurope, which represents the national associations of pension funds and similar institutions for funded pensions in 18 EU member states and 3 other European countries, has already reacted to the EIOPA opinion with several objections. Primarily, PensionsEurope objects to the opinion's "one-size-fits-all" approach to IORPs, but makes several specific objections, including:

- "The Opinion misrepresents the legal framework set by IORP II by indicating that IORPs are required to take ESG factors into consideration as part of the investment policy, when that only requires that Member States do not ban the consideration of the impact of investment decisions on ESG factors. Moreover, the Directive explicitly mentions that IORPs can opt-out of incorporating ESG factors in investment decisions, which is not mentioned at all in the Opinion."

- "The Opinion urges National Competent Authorities to push IORPs towards impact investing when it argues that 'NCAs [national supervisory authorities] should encourage IORPs to take into account the potential impact of investment decisions on ESG factors in order to support society's sustainability goals'. While there are IORPs that want to make a societal impact, the primary duty of an IORP remains to ensure good pension outcomes for their members. Any societal objectives can be adopted voluntarily, but should not be forced upon pension funds by supervisors."

Conclusion

Of course, it remains to be seen how the country pension regulators will transpose this opinion into local law, and though "the objective of this Opinion is to promote consistent supervisory practices by providing CAs [supervisory authorities] with guidance on the supervision of IORPs' management of ESG risks through their risk-management system and own-risk assessment", there is a question of how uniform it will be. The UK, which may or may not still be part of the EU after next October, will begin to require disclosure by pension trustees of ESG consideration in October. Whether EIOPA may take into account some of the comments and objections to the opinion also remains to be seen.

If you are interested in this subject and how it may impact your global benefits governance, please contact David Powell or your regular Groom lawyer.