



PensionsEurope Position Paper on the Commission's Legislative Package on Sustainable Finance

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Key messages

PensionsEurope welcomes the EU's agenda on sustainable finance. Pension funds are long-term investors that aim to deliver adequate pensions for their members and beneficiaries. This means they naturally take the long view and are required to consider the long-term risks that may affect their portfolios. Targeted policy initiatives on sustainable finance can catalyse ongoing initiatives within the financial sector. In this respect, better data on companies and other investments, clearer definitions on what is considered sustainable and more transparent financial services will help to address some of the barriers pension funds face when wanting to invest more sustainably.

PensionsEurope sees the taxonomy as an *enabler* for integrating ESG factors in investment decisions. If designed properly, it can help pension funds to better understand and measure the sustainability risks in their portfolios. It can also serve as a basis for discussions with investment managers about ESG integration when agreeing mandates or selecting investment funds. Finally, it can be a valuable tool to provide information to members and beneficiaries.

The taxonomy is a useful tool, but not a silver bullet. It does not capture all sustainable investment approaches and therefore should not become synonymous with responsible investing. Moreover, pension funds need strong evidence of the taxonomy's reliability before incorporating it in IORP stress tests or prudential frameworks.

The current understanding of fiduciary duty already today fosters sustainable investments. Moreover, under the most recent codification of the fiduciary duty for pension funds, i.e. the 'prudent person' rule in IORPII, specifically allows for the consideration of ESG factors and requires pension funds to take into account the **long-term interest** of their members and beneficiaries. Over the last years there has been a clear trend in the pensions sector towards sustainable investment. There are many best practices and approaches of how pension funds consider sustainability factors. PensionsEurope believes that the EU should not harmonise how pension funds manage their sustainable investments.

The ESG framework for IORPs is the most advanced amongst financial market actors. IORPs are required to incorporate ESG factors in their governance and risk management systems. Member States have yet to transpose these requirements into national law before January 2019.

The EU should first assess how the IOPR2 Directive's ESG provisions are put into practice, before making amendments. The European Commission's own Better Regulation Guidelines prescribe that policy-making should be based on the 'evaluate first' principle. PensionsEurope therefore strongly believes that the Commission should make use of the IORP2 Review clause. This would allow for sufficient time to understand how the new rules are being incorporated in governance, investment decisions and risk management of IOPRs.

Delegated acts are an inappropriate legislative tool to regulate occupational pensions. The IORP2 Directive only provides for minimum harmonisation, recognising the diversity of the IORP landscape in Europe and the role of national social and labour law for occupational pensions. To acknowledge this fact, all delegated acts proposed by the Commission in March 2014 were removed from the IORP2 Directive by the co-legislators. Different financial sectors have different roles and obligations towards their clients or members. It is therefore not necessary to employ a harmonised approach across sectors to amending the fiduciary rule through delegated acts.

Taking into account the ESG preferences of members and beneficiaries.

There are different ways of obtaining an understanding of the preference of members and beneficiaries. In many cases, their representatives are present in supervisory boards and other representative bodies, bringing expertise and competence to the table. There are significant challenges to obtaining a representative overview of the whole group of members and beneficiaries when using direct consultation. In practice pension funds experience low response rates to questionnaires, leading to a skewed picture of the preferences. An EU wide requirement would also struggle to take account of the specific national governance structures of pension funds, as well as the responsibilities entrusted to trustees or Board members, including member representatives.

Introduction

The Commission published a legislative package on sustainable finance on 24 May 2018, containing three proposals for regulations:

- A proposal for a regulation establishing a unified EU classification system of sustainable economic activities COM(2018) 353.
- Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU) 2016/2341 COM(2018) 354.
- Proposal for a regulation amending Regulation (EU) 2016/1011 on low carbon benchmarks and positive carbon impact benchmarks COM(2018) 355.

PensionsEurope welcomes the EU's agenda on sustainable finance. Pension funds are long-term investors that aim to deliver adequate pensions for their members and beneficiaries at low costs. This means they naturally take the long view and are required to consider the long-term risks that may affect their portfolios. Moreover, there is a long tradition of aligning investment practices with the values of their membership and increasingly society at large. The first responsible investment strategies of pension funds focussed more narrowly on ethical exclusions (e.g. controversial weapons or the tobacco sector), but a wider array of more sophisticated methods is becoming mainstream. This trend will only continue as the impact of climate change is becoming more apparent and members and beneficiaries are increasingly vocal through their representatives about their expectations relating to the broader impact of the assets managed on their behalf.

Targeted policy initiatives can catalyse ongoing initiatives within the financial sector. The lack of high-quality comparable data on ESG factors is one of the key barriers for ESG incorporation. This makes it costlier and more difficult to apply ESG factors consistently across the investable universe. Better information on companies and other investments, reliable definitions and more transparency about how providers of financial products and services incorporate ESG can enable and encourage pensions to expand their responsible investment strategies. This means that pension funds should and also do disclose how they consider sustainability factors in their investment processes.

At the same time, regulatory intervention needs to take account of pension funds' primary role of providing a retirement good income to their members and beneficiaries. Investments are an essential part of pension provision: historically, around three quarter of the realised pension benefits at retirement age resulted from return on investments. Regulation should therefore not lead to pressure, formally or informally, to invest in or divest from certain assets where the pension fund believes the investment still provides a sound long-term risk-adjusted return. The fact that the EU is taking a comprehensive approach including all sectors of the financial system does not mean that this should lead to a uniform regulatory approach. Pension funds are covered by a principle-based minimum harmonisation framework where Member States retain sufficient flexibility to adjust the rules to their domestic pension systems, as well as social and labour law. Finally, the IORP2 Directive is still under implementation. From a 'better regulation' standpoint, it would be best to assess how the new ESG provisions are transposed and put into practice, before amending them.

Views on the proposal for a taxonomy for environmentally sustainable activities

The High-Level Expert Group on Sustainable Finance found in its report on January 2018 that the lack of common definitions on what constitutes 'sustainable', is harming investor confidence in environmental, social and governance (ESG) investments. Both for retail and institutional investors it can be unclear at times whether the composition and performance of their 'sustainable' investments

indeed match their sustainability preferences. Moreover, there is a lack of comparability between investments and products.

To mitigate these challenges the High-Level Expert Group proposed to establish a science-based objective classification system to assess the sustainability of economic activities. The European Commission has now published a draft regulation to serve as the basis for the taxonomy for environmental sustainability.

The taxonomy as *enabler* for responsible investments

PensionsEurope welcomes the taxonomy as an *enabler* for integrating ESG factors in investment decisions. If designed properly, it can help pension funds to understand and measure the sustainability risks in their portfolios. It can also serve as a basis for discussions with investment managers about ESG integration when agreeing mandates or selecting investment funds. Finally, it can be a valuable tool for providing information towards members and beneficiaries.

It is important that the proposed framework regulation and the ongoing works of the technical expert group on that same subject are well coordinated in order to mutually reinforce each other whilst limiting the administrative burden for institutional investors. The works on taxonomy at European level require embedding them into a broader policy framework of environmental, governance and social policies.

In order to achieve these goals, the taxonomy should be aligned with international standards and the EC's better regulation agenda, science-based and flexible. However, even if set up in a flexible manner, we expect that technological changes mean that the taxonomy needs to be updated regularly, as some economic activities may become more sustainable whilst others, comparatively, less so. PensionsEurope welcomes that the Commission is proposing to set up a platform for sustainable finance. PensionsEurope and its members are ready to provide their expertise and be actively involved in this platform.

Policy-makers should recognise the taxonomy is not a silver bullet

It should be recognised that the taxonomy offers an assessment of whether activities are environmentally sustainable, which does not capture all responsible investment approaches. For example, some asset owners use a best-in-class approach. Others put more emphasis on changing the behaviour of their portfolio companies through engagement. It is therefore important that having a high share of ESG assets under the taxonomy does not become synonymous with responsible investment or ESG investing. The taxonomy is a useful tool, but not a silver bullet. Under no circumstance should there be regulatory pressure to invest into assets just because they are in scope of the taxonomy.

Moreover, policy-makers should be very careful before making the use of the taxonomy mandatory as a risk-management tool or incorporating it into IORP stress tests. However carefully designed, it is far from inconceivable that the taxonomy will overstate or understate some types of ESG risks. A too strong and harmonised dependency on the taxonomy could then lead to green bubbles. Similarly, as both investors and customers of the banking and insurance sector, PensionsEurope believes prudential frameworks should remain risk-based. While some argue that ESG risks are sufficiently material to include them into prudential frameworks, there is a risk that politicians wish to achieve political objectives by tweaking risk weights or capital charges. There needs to be strong evidence of how 'green' support or 'brown' penalising factors contribute to financial stability, before such measures should be adopted.

The taxonomy as an enabler for the transition to a more sustainable economy

PensionsEurope would prefer if the taxonomy would recognise efforts by companies to transition towards a more sustainable business model. Pension funds would not like to exclude entire sectors from the investment universe. A best-in-class or best-in-progress approach therefore aims to identify companies that are improving their sustainability impact rather than being in a sector that is perceived as clean but standing still. A taxonomy that would provide a pathway for these improving companies, could serve as valuable input into pension funds' investment decision-making.

The taxonomy should be extended to social and governance factors

PensionsEurope notes that it makes sense to take a staggered approach to the development of the taxonomy, starting with climate change mitigation and adaptation in particular. The implementation of the Paris Agreement requires swift policy action. Moreover, designing a sound taxonomy is a challenging task so it is crucial to gain experience and continuously assess its reliability while rolling the taxonomy out to all areas of environmental, social and governance factors. Nevertheless, there should be a clear ambition to complete taxonomy across the three tenets. Currently, the integration of governance factors is arguably the most advanced. Moreover, especially in countries where the social partners play a significant role in the governance of occupational pensions, pension funds are naturally close to socially sustainable investments.

Views on the proposal on disclosures and investor duties

The High-Level Expert Group (HLEG) report of 31 January 2018 recommended that the EU should clarify and streamline provisions on the fiduciary duty or 'investor duties'. According to the HLEG, the misconception that the fiduciary duty requires fiduciaries to solely focus on the short-term maximisation of returns would constitute a barrier to incorporating longer dated ESG risks into investment decisions. Therefore, it was argued that EU regulation should require asset owners and investment intermediaries to examine the materiality of risks and value drivers, including ESG factors, consistent with the timeframe of the obligation to the client or beneficiary/member.

On 24 May 2018, the European Commission published a Proposal for a regulation on disclosures relating to sustainable investments and sustainability risks and amending Directive (EU)2016/2341. The proposal is the first step in a two-stage approach to implementing the HLEG's recommendation on the fiduciary duty. It introduces transparency requirements for financial market participants to demonstrate the extent to which they currently use environmental, social and governance (ESG) factors. It also proposes the power for the European Commission to adopt delegated acts under the Institutions for Retirement Provision Directive (IORP 2) to ensure that ESG factors are included in investment decisions. If this delegation of power is approved by the co-legislators, the Commission aims to adopt a package of delegated acts for all relevant financial actors, including pension funds (IORP), insurers (Solvency II) and asset managers (amongst others UCITS and AIFMD).

A modern understanding of the fiduciary duty is not a barrier to the incorporation of ESG factors

Historically, the fiduciary was interpreted as meaning that fiduciaries should only seek to maximise the risk-weighted returns of the investments entrusted to them. This limited the extent to which investors should or could incorporate ethical concerns in their investment decisions. ESG factors were seen as financially non-material and were therefore not allowed to play a significant role. However, this understanding progressively changed through changes in case law and regulation, as well as the emerging view that the incorporation of financially material ESG factors could in fact lead to better risk-weighted returns. This led the UNEP FI to conclude already in 2005 that across the developed world ESG incorporation had become permitted if not required under the fiduciary duty where the

fiduciary believed it would lead to better performance. ESG factors are also allowed to be the decisive factors between several potential investments with a comparable expected return.

Over the last years there has been a clear trend in the pensions sector towards sustainable investment. There are many best practices and approaches of how pension funds consider sustainability factors. This diversity in approaches stems from a large number of factors, which includes, for example, societal preferences (e.g. stronger focus on environmental concerns over social aspects or vice versa), the size of funds or the occupational pension system overall, the position of the sponsoring company towards ESG aspects, the role of the social partners and the preferences of members. This shows that the current understanding of the prudent person rule, as laid down in the IORP2 Directive and transposed into national law, has not proven to be a barrier towards sustainable investments.

The ESG framework for IORPs is the most advanced amongst financial market actors and still under implementation

Pension funds are governed by the IORP Directive, the review of which was agreed in December 2016. IORP2 is still being implemented and the deadline for transposition into national law by Member States is January 2019. The review contains several new provisions relating to ESG factors, making it more advanced than the frameworks for other financial market participants:

- **Prudent person rule:** codifying the EU version of ‘fiduciary duty’, the prudent person rule dictates how IORPs should invest in the best **long-term** interests of members and beneficiaries. The HLEG report highlighted how short-termism in financial markets can form an obstacle to the establishment of a sustainable financial system, but IORPs are already explicitly required take the long view when investing assets. Moreover, IORP2 also specifically allows “IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors”¹.
- **Governance requirements:** “the system of governance shall include consideration of environmental, social and governance factors related to investment assets in investment decisions”²
- **Risk-management:** IORPs are required to have a permanent risk-management function to identify and report a broad spectrum of risks the funds faces, so that the Board can take action to mitigate these risks. The risk-management function has to be well-integrated into the IORPs organisational structures. The IORP2 Directive specifically requires IORPs to cover “environmental, social and governance risks relating to the investment portfolio and the management thereof”³.
- **Own-risk assessment:** next to having a permanent risk-management function, IORPs are also required to conduct own-risk assessments at least every three years, or whenever the risk profile of the IORP changes significantly. This assessment feeds into the strategic decision-making process of the IORP. Where environmental, social and governance factors are considered in investment decisions, the IOPR should asses “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”⁴.
- **Proportionality:** there can be huge differences in the size of IORPs: from single member IORPs, to medium-sized business pension schemes with a few hundreds of beneficiaries, to sector-wide funds with tens or even hundreds of billions of Euros under management. In view of the

¹ Article 19 (1) b

² Article 21(1)

³ Article 25(2)g

⁴ Article 28 (2) h

diversity of the pension fund landscape, the co-legislators decided to instruct Member States to make most of the IORP2's requirement proportionate to the size, nature, scale and complexity of the IORP. This applies to the governance requirements, the risk-management function and the own-risk assessment, and therefore also the specific ESG elements thereof.

The EU should first assess how the IORP2 Directive's ESG provisions are put into practice, before making amendments

The European Commission's own Better Regulation Guidelines prescribe that policy-making should be based on the 'evaluate first' principle. The purpose is to gain valuable insights in the effectiveness, efficiency, relevance, coherence and added value of EU intervention⁵. Therefore, EU directives and regulations usually have built-in review clauses that allow for sufficient time for market participants to implement and gain experience with new rules. In the case of IORP2, a review is foreseen by January 2023 (Art. 62 IORP Directive). However, the Commission has proposed to amend these provisions before they are even put into practice. By changing legislation that is under transposition, the Commission is creating a moving target for both national law-makers and pension funds.

PensionsEurope therefore strongly believes that the Commission should make use of the normal IORP2 Review clause. This would allow for sufficient time to understand how the new rules are being incorporated in governance, investment decisions and risk-management of IORPs. In particular, it would permit an assessment of the interplay of these rules with EU initiatives that can serve as enablers of sustainable investments, such as the taxonomy, low-carbon benchmarks and the disclosure rules from this proposal. To ensure that ESG factors are sufficiently considered within the review, the Proposed Regulation could amend the IORP2 by adding ESG factors as a point to Art. 62(2).

Delegated acts are an inappropriate legislative tool for IORPs

The IORP2 Directive only provides for **minimum harmonisation**, recognising the diversity of the IORP landscape in Europe. IORPs are embedded in historical developments in Member States and in their respective social and labour laws. They are, first and foremost, social institutions delivering retirement income to their members. Occupational pensions are also built on the foundation of first pillar pensions (state pension systems), which are different from Member State to Member State. Therefore, occupational pension design, in conjunction with widely-varying first pillar pension provision, aims to achieve adequate pensions overall, with the definition of adequacy being highly dependent on the social policies of a Member State (housing, health care, social welfare). Moreover, the role of the social dialogue and level of involvement from social partners also differs significantly between Member States, leading to different pension fund governance models.

The co-legislators therefore refrained from harmonising the prudential framework. National prudential legislation and supervision, based on the IORP Directive, were seen to better take the above mentioned national elements into account. This also meant that all delegated acts were removed from the Commission proposal, as this legislative tool would lead to harmonisation in an area where it is not warranted. Pension funds strongly welcome this as they were concerned that EIOPA, which was in favour of a harmonised EU prudential framework, would otherwise be able to make use of Level 2 measures to put in place Solvency2-like requirements. This is why PensionsEurope, as a matter of principle, does not support the introduction of delegated acts in IORP2.

Moreover, the Commission has alleged that a uniform approach to amending investor duties is required and therefore delegated acts must be used for the insurance, asset management and pension fund sectors. IORPs have a different role compared to other institutional investors. In contrast to

⁵ "Better regulation guidelines - Evaluation and fitness checks", European Commission ([link](#))

providers of investment products, IORPs - on the basis of a contractual relationship between employers and employees - ensure that occupational pension benefits are being paid. For IORPs, cross-border activity is marginal. PensionsEurope therefore believes it is not appropriate to deliver the HLEG's recommendation through a uniform set of measures contained in a package of delegated acts.

Taking into account the ESG preferences of members and beneficiaries

Pension fund trustees are required to act in the best interest of the beneficiary and member. In many countries, members are involved in key decisions through their representatives which sit in the decision-making bodies, e.g. supervisory boards, of the pension fund. This has a number of advantages: the representatives hold such an office for several years, building up competence and experience, often considering questions in greater detail than a regular member would. In addition, representatives can obtain advice and exchange information amongst each other.

Some pension funds are consulting their beneficiaries directly on their preferences regarding sustainability factors. In most cases this consultation is conducted through questionnaires, but some funds employ other methods, such as focus groups. However, there are significant challenges to obtaining a representative overview of the whole group of members and beneficiaries. In practice pension funds experience low response rates to questionnaires, leading to a skewed picture of the preferences, with only individuals with a very strong view responding. Communicating with members and beneficiaries is made more difficult by the fact that there is no academic consensus about the relationship between ESG factors and returns, ways to measure the impact, as well as challenges relating to financial literacy more generally.

An EU wide requirement would also struggle to take account of the specific national governance structures of pension funds, as well as the responsibilities entrusted to trustees or Board members. Moreover, if trustees or pension fund board members would be required to not incorporate the views of members and beneficiaries in case they believe it is not in the members and beneficiaries' best interest, this could lead to confusion and disengagement

Views on the proposal on low and positive carbon benchmarks

Overall, PensionsEurope supports the approach of the Commission to create a new category of benchmarks, meaning that asset and portfolio managers who claim to pursue an investment strategy compatible with the Paris Climate Agreement should therefore use positive carbon impact benchmarks. However, we would like to point out that the benchmark regulation should under no circumstances lead to pushing investors into certain investments. We are therefore concerned about Amendment 13⁶ tabled in the ECON Draft Report by Rapporteur Neena Gill (S&D, UK): it would introduce a requirement for all benchmarks by 2022 to be positive carbon impact benchmarks. This means that investors would no longer be able to use or construct benchmarks as they see fit, but rather have to use positive carbon impact benchmarks. It would lead to a move away from all other ESG considerations solely towards carbon, potentially increasing risks because of this concentration. It

⁶ Amendment 13: „The following subparagraph 1a is added:

‘By 2022, benchmark providers will ensure that all the benchmarks provided and published are positive carbon impact benchmarks, fully aligned with the Paris Climate Agreement commitments as implemented in Union law and this according to a standardised methodology which will be developed by the Commission in a delegated act published not later than two years after the entry into force of this regulation. In the delegated act the Commission will refer to existing Union frameworks setting out uniform criteria to determine the suitability of an economic activity for the purposes of determining the degree of sustainability of an investment.’“ ([ECON Draft Report](#))

would severely interfere with market forces, undermining the idea of using these forces to allocate capital to the best ESG initiatives. Similarly, we would caution against the proposals made in Amendment 6, that “by 2022, all asset and portfolio managers should pursue an investment strategy fully aligned with the Paris Climate Agreement commitments as implemented in Union law”.

About PensionsEurope

PensionsEurope represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **23 member associations** in 18 EU Member States and 3 other European countries⁷.

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people**. Through its Member Associations PensionsEurope represents more than **€ 4 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **30 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns;

Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often “not-for-profit” and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

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⁷ EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.