efama

European Fund and Asset Management Association

European Commission's
Public consultation on long-term and sustainable investment
EFAMA Final Response
ID Number: 3373670692-24

About the respondent

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 61 corporate members EUR 21 trillion in assets under management of which EUR 12.6 trillion managed by 56,000 investment funds at end 2015. Just over 30,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 25,900 funds composed of AIFs (Alternative Investment Funds). For more information about EFAMA, please visit www.efama.org.

Executive Summary

Importance of Responsible Investment

Responsible investment 'RI' is an integral part of the investment process for many EFAMA members. Asset managers invest in the best long-term interest of their clients and are aware of the environmental, social and governance 'ESG' challenges that can influence investment performance. There has been a recent surge in RI, due to the growing interest of beneficiaries in ESG factors. Increasingly, asset managers see their capacity to integrate RI in investment processes and decisions as part of their operational excellence and a key element of their competitive advantage. By listening to its clients, the asset management industry is scaling up ESG investing in accordance with investor demand.

A non-regulatory issue

EFAMA sees RI as a non-regulatory issue, acting beyond the realm of legislation. RI is a diverse and growing field, where many methods of selecting ESG friendly investments are used, and where asset owners have to decide on standards, ethical or social norms. Regulatory requirements would make ESG investments a compliance issue and as a result the importance of the conviction of the positive effects of ESG investments would diminish.

rue Montoyer 47, B-1000 Bruxelles
☎ +32 2 513 39 69 • Fax +32 2 513 26 43 • e-mail : info@efama.org • www.efama.org • VAT Nr BE 0446.651.445

The importance of asset owners' view of the world & fiduciary duty

The first step in the RI process is for asset owners to define their values and objectives and how they are to be incorporated, if at all, into their investment mandates. Asset owners' view of the world, political ideas and values come into play, leading to a wide variety of choices.

In terms of integrating ESG factors in the investment process, the fiduciary role of asset managers, acting on behalf of investors and beneficiaries, has been clarified in two reports by Freshfields (2005) and UNEP FI (2009) respectively. ESG factors should be taken into account in investment decisions when it is in the best interests of the beneficiaries and should be embedded in the legal contract between asset owners and asset managers.

Responsible Investment & Performance

EFAMA believes the risk-return-cost triangle in RI is not any different from other investment beliefs. In fact, RI is a means by which risk can be reduced, while keeping up with returns. Asset managers are increasingly incorporating RI analysis into the selection and management of investments as a means of reducing risks.

Questions

1. Rationale for ESG inclusion into investment decisions

1. a. Do ESG factors play a role in the investment decisions of investors? If not, why? If yes, please specify which considerations are reflecting in your investment policy and mandates? In what form is this commitment expressed?

As the representative trade body of the European asset management industry, EFAMA speaks on behalf of asset managers in Europe, who manage money on behalf of their clients, retail or institutional investors. While we have answered many of the questions in this consultation where the point of view of the institutional investor is sought, we do so as agents who invest on behalf of our clients, the investors.

ESG factors play an increasingly important role for retail and institutional investors (see data from answer 6c). The aim of integrating ESG factors in investment decisions is both financial and non-financial. The recognition of the impact of economic sustainability on longer term value creation, as well as the changing social and ethical values of asset owners and the broader public have strongly influenced this transition.

The investment policy, as determined and agreed by the asset owner, is set out in the fund documentation or is in the discretionary portfolio management contract.

1. b. What is the main rationale for institutional investors and asset managers to take ESG risks and opportunities into account in their investment decisions? Please indicate all the relevant issues (multiple choice)

- ☒ **a) risk management:**
- ☒ **b) alignment of investment policies with the long-term interests of beneficiaries of the institutional investor,**
- ☒ **c) pressure from clients on whose behalf the institutional investor invests funds,**
- ☒ **d) seeking a positive social or environmental impact of investments,**
- ☒ **e) ethical considerations,**
- ☒ **f) legal or regulatory constraints, please specify,**
- ☒ **g) other, please specify:**

a) risk management:

- ☒ **i) managing asset value risk in the short-term, including preservation of investment value, better investment performance,**
- ☒ **ii) managing asset value risk in the medium-to long-term, mitigation of exposure to long-term and systemic risks,**
- ☒ **ii) management of liability risks,**

f) legal or regulatory constraints, please specify:
Mandatory investment exclusions are in force in several jurisdictions in the world. While there is a cluster munitions ban in many European countries, the rules differ from one country to another on the level of practical detail.

Other legal and regulatory requirements can also be a factor for institutional investors and asset managers taking ESG risks and opportunities into account in their investment decisions, such as the new French law on ESG/low carbon investment reporting. However it is too premature to assess the impact of these new measures.

g) other, please specify:
Increasing performance, long-term value creation, long-term economic sustainability

Please provide an explanation:
Not applicable.

2. <u>Information on ESG risks and opportunities</u>

2. a. Which ESG risks do you perceive as material to investors?

ESG risks considered 'material' to investors are those that are financially relevant, or in other words that affect economic behaviour. Materiality has two components: (1) financial gain or loss and (2) risk. Investor behaviour is not only affected by a change in profitability or market value of a company, it is also impacted by a change in (perceived) investment risk. The nature of such a risk is often industry-specific or sector-specific (such as extractives industries, alternative energy). Market

specificity is also a very real consideration in investment attractiveness. Companies listed in markets where transparency is poor, market controls are weak or minority shareholder rights are diluted often trade at what is called a “governance discount”. These are typically emerging markets, e.g., Russia, Korea.

It should be noted that there is also a segment of clients who want ESG considerations incorporated into their investment decisions, even if it is not material in the financial sense.

2. b. What are the main sources of reliable and relevant information for investors on material medium- to long-term risks and opportunities, particularly on ESG issues?

There are several sources of information for investors on material medium-to long-term risks and opportunities, including ESG issues:

- As part of their Corporate Social Responsibility ‘CSR’ implementation, companies produce annual reports, covering ESG issues
- Research by data providers including specialised ESG data providers and brokers, produce an increasing number of increasingly elaborate studies on SRI and sustainable development
- Other sources include materials from NGOs, the press and public documents, unions and scientific reports

2. c. Is it difficult for investors to access such information? If so, please specify:

The information is increasingly available and companies are more open to communication. However it remains sometimes difficult to access such information. Firstly, not all issuers provide non-financial information in their annual reports. Secondly, even when issuers provide non-financial information, comparability between issuers can be an issue. Access to empirical data can be particularly challenging for many medium to long term risks, particularly for smaller issuers or issuers in emerging / developing markets. It can also sometimes be the case that reliability and credibility of the data is uncertain.

2. d. Is access to such data expensive? If so, please specify:

Data often has to be obtained from independent data providers, who charge for their services. The average price for an extra-financial data provider is k$100. For an asset manager with $ 100 bln assets under management ‘AuM’, it represents 0.01 bps. This would represent 1% for a small asset manager with 10 million AuM. Expensive is a relative term; in this case the costs should be related not just to AuM, but also to the expected returns for the asset owner. It is up to the asset owner to judge whether the extra effort is worth the price.

2. e. What factors may prevent or discourage companies from disclosing such data?

Governance structure and shareholder structure may prevent or discourage companies from disclosing such data. For example, where a company has a large controlling shareholder, it may consider it unnecessary to improve transparency as the large shareholder provides in effect a shield

from minority shareholders' views or votes.

Even when the governance structure and shareholder structure does not discourage companies disclosing data, market practice may do so. Where disclosure is not common practice amongst peers, the company may not want to be a "first mover". This is also closely interlinked with the regulatory framework: where disclosure is not mandated, the company may consider it better to provide the minimum disclosure required, i.e., "why disclose what we don't have to?"

Finally, other issues such as reputation, cost and time as well as trade secrets may also be factors preventing or discouraging companies from disclosing data.

2. f. What is the main rationale for companies to publish such information? Please indicate all the relevant issues. (multiple choice)

☒ **a) relevance of ESG issues to company performance**
☒ **b) attracting financing for specific projects, for example green bonds**
☒ **c) legal or regulatory constraints**
☒ **d) demand from investors**
☒ **e) pressure from stakeholders**
☐ **f) other**

f) other, please specify:
Not applicable.

2. g. Is there sufficient accountability for the disclosure by companies of such information?

The Board of Directors of companies is generally regarded as being responsible for a company's corporate governance practice, including disclosure. Shareholders must determine whether the Board merits continued support if an acceptable level of disclosure is continuously not forthcoming. However, stock exchanges can help by embedding a standard of more meaningful disclosure within their listing rules.

2. h. What are the best practices as regards internal corporate governance processes to ensure proper reliability of the disclosed information?

EFAMA sees the quality of companies' Board of Directors to be key for companies' processes, including corporate governance processes.

In particular, the quality of the Board members and the Board's diversity (not only the gender diversity but also professional diversity, nationality, experience in different markets where the company has a large operational presence or consumer base, technical skills) are vital. This should include a good process of Board evaluation focused on board composition as a whole. Focus on independent directors rather than executive directors is important as the quality of the executive

directors is reflected in the price of the shares. However, non-independent non-executive directors can (and should) also bring considerable and relevant knowledge to the board. Essentially, board quality is reflective of the quality of the entire board, how the directors work together, the quality of discussion and challenge they are able to have.

In EFAMA's view, independent directors can be better placed to guarantee the independence and quality of the process to the market and shareholders. This is in part because shareholders will see them being free of conflicts of interest, in addition to their added value in terms of qualifications and experience.

Engagement with investors could therefore involve both management and non-executive directors. There are many asset managers and asset owners who believe that there are are tangible benefits to Boards and investors having direct dialogue / engagement on key corporate governance matters, including how boards oversee management's approach material impacts on the business. Engaging with board directors gives investors a sense of the board's calibre, the level of engagement with management and the effectiveness of board meetings and decision-making. While there are circumstances where it will be more appropriate for shareholders to meet with a member of executive management, there are also likely to be occasions where it will be most effective for a particular member of the non-executive Board (for example the Board Chair or the Chair of a particular Board Committee, the lead independent director) to engage directly with shareholders, depending on the issue being discussed. In any case, such communication by the Chair, CEO, or lead independent director should follow the positions defined collectively by the Board, taking into account, among other things, governance policies, finance and operational discussions. It should be noted that there also asset managers who do not engage in direct dialogue with individual members of the Board of the company and instead prefer to engage with specifically appointed persons in the company because of potential conflicts of interest surrounding market abuse issues.

2.i. What is the role of specific ESG investment instruments, like green bonds?

ESG instruments can provide choices to those investors that have very specific views/values/objectives when it comes to ESG implementation. Specific ESG investment instruments, such as green bonds, can help investors achieve ESG goals in different ways to equity investments. However, we need to be cognisant that markets do not become fragmented as a result of a broad introduction of different but similar products.

Specifically on green bonds:

Green bonds, or climate bonds, are fixed income securities issued by an organisation, whose use is predefined and made transparent by the issuer to finance specific environmental (or, according to some, social) activities.

Credit enhancement programmes (i.e. guarantees, subordinate debt or insurance), tax incentives or financial regulatory measures have been introduced in some instances to improve the risk-return profile of green bonds or generally boost demand, especially in the context of climate change programmes. This could potentially make green bonds more attractive to issuers and investors alike,

than comparable conventional bonds. Some governments already have tax incentives for 'green investing', but they are not always tuned to bonds.

EFAMA believes the green bond concept will lead to both a shift of capital streams and the raising of new financing. "Repackaging" is inevitable, however, brand diversification usually adds to the volume (both supply and demand) of the total market. More importantly, there is already anecdotal evidence that clients interested in RI are likely to prefer green bonds above ordinary bonds. This may in the future affect their relative pricing, and thus yield. Issuers are also speculating that increased future demand will lead to more favourable terms and a better price for the issuer.

3. <u>Integrating ESG information into risk assessment models of institutional investors and asset managers</u>

3. a. What should an appropriate long-term risk assessment methodology look like? Please indicate some examples of good practice.

Developing long-term risk assessment methodology where risks are quantified would require more transparency of ESG data in all different sectors of the economy, in a standardised way, based on the Global Reporting Initiative 'GRI', Sustainability Accounting Standards Board 'SASB' or the International Integrated Reporting Council 'IIRC'. It would also, in general, require bigger data sets over a longer term than are available currently.

RI and RI integration is a young and highly innovative field combining knowledge from various sciences, and one where asset managers' approaches to ESG vary. ESG investing is a diverse field where asset owners have to decide on standards, ethical or social norms. The first step is for asset owners to define their values and objectives and how they are to be incorporated, if at all, into their investment mandates. Asset owners' view of the world, political ideas and values come into play, leading to a wide variety of choices. The concept of ESG investing is therefore not to be captured by a single regime. The aim should be to develop procedural standards focused on including ESG factors in investment analysis at European level for investment managers, which would enable investors to evaluate different approaches to responsible investment and allow for informed choice in the marketplace.

3. b. Are there specific barriers, other than those of a regulatory nature (see question 9) for investors to integrate medium-to long-term risk indicators, including ESG matters in their risk assessment? If so, please indicate what you consider to be the main barriers.

There are several non-regulatory barriers in integrating medium-to long-term risk indicators, including ESG matters in their risk assessment:

- ESG factors in investment are essentially externalities (in economic terms) and are difficult to measure in financial terms. This risk for investors is ultimately a risk of losing financial value.

- For passive management (index-tracking funds), there is no risk assessment pre-investment,

therefore any consideration of ESG matters in investee companies will have to be done post-investment through engagement.

- The asset owner, the client of the asset manager should have a final say on what investment belief is followed in relation to their assets, either by contracting on it (in the case of mandates) or by subscribing to a fund whose investment strategy they abide by.

- There are many misconceptions in the general public about ESG investing (some consumer research indicates the public believes responsible investing always has a detrimental effect on returns) and the public's attitude has been under researched.

4. <u>Integration of ESG aspects in financial incentives</u>

4. a. When selecting and remunerating asset managers, how do institutional investors take into account asset managers' integration of ESG issues into investment strategies? What are the best practices in this area?

A questionnaire by the Principles for Responsible Investment 'PRI', which is compiled in "transparency reports" activities for all investment manager signatories to the PRI http://www.unpri.org/signatories/signatories/#investment_managers, provides transparency on responsible investment activities of all signatories. A copy of this report is publicly disclosed for all reporting signatories on the PRI website.

4. b. Is ESG performance and active asset ownership taken into account in the remuneration of the executives and/or board members of institutional investors? What are the best practices in this area?

Asset Managers are intermediaries in the investment chain so the decision as to how incentivise the asset manager lies with the asset owner / institutional investor. The Revision of the Shareholders' Rights Directive 'SRD II', currently under discussion, will require institutional investors to disclose the long-term focus of asset managers' remuneration.

Remuneration will also depend on the mandate and investment strategy, whether it is active or passive, the priorities, and the focus / balance between returns and ESG values. Ultimately, it is up to the client / asset owner to determine its chosen performance measures.

5. <u>Capacity of institutional investors</u>

5. a. Do you think that the lack of scale or the lack of skills and resources of some institutional investors may affect their ability to integrate ESG factors in investment decision-making and engage on such issues? If so, how? Please provide evidence if possible.

While some asset managers provide ESG investing services as a part of their corporate profile or mission statement, most asset managers provide it if and when their clients ask for it. ESG investing is more prevalent with larger asset owners than it is with smaller ones, and the larger owners will ask their asset managers to provide that service. However, there are also many smaller asset managers who provide these services. Overall, there is certainly a scale issue in terms of engagement.

Undoubtedly, economies of scale play a role in financing the extra expenses involved in ESG analysis and activities. It is evident that ESG investing involves additional costs (for example research and analysis), and these costs are deducted from the asset owners' return. There is however no reason to treat the risk-return-cost triangle in ESG investing any different from other investment beliefs.

Integrating ESG into the investment process is usually a follow-up step after an ESG overlay. It involves multi-disciplinary teams with different knowledge and skill sets. It may also involve IT projects. There are also more ways than one to integrate ESG into the business processes.

Ultimately, there is also the lack of consensus on what is important and why. Values are often confused with what should be regarded as operational excellence.

5. b. Please indicate measures/practices that have contributed to enhance institutional investors' capacity and ability to integrate ESG factors in investment decision-making and engage on such issues.

- For asset owners and asset managers who are practicing ESG investing, it is vital to have reliable and accurate reporting on ESG issues by corporations they invest in or are considering investing in. It improves the quality of information available to asset owners and asset managers and facilitates their own reporting on ESG issues. The International Integrated Reporting Framework 'IIRF' by the IIRC and the SASB are excellent initiatives in this respect.

- Internationally, recognised principles and guidelines, such as the OECD Guidelines for Multinational Enterprises, the Ten Principles of the United Nations Global Compact, the ISO 26000 Guidance Standard on Social Responsibility, the ILO Tri-partite Declaration of Principles Concerning Multinational Enterprises and Social Policy, and the United Nations Guiding Principles on Business and Human Rights are important reference points and benchmarks.

- Recent EU legislation is also likely to help in the near future:

    - The Transparency directive (2013/50/EU) requires companies whose securities are admitted to trading on a regulated market and who operate in 'extractive industries' (i.e. oil, gas, mining and forestry) to publish payments to governments in countries where they operate (country-by-country reporting). Member States had to transpose the Directive by November 2015.
    - Disclosure of non-financial and diversity information by public interest entities and groups with over 500 employees in Directive 2014/95/EU (which amends the Accounting directive, 2013/34/EU). The rules will apply to all undertakings for the financial years starting in 2017.

- In March 2014, the European Commission introduced a proposal for a Directive of the European Parliament and of the Council on the activities and supervision of institutions for occupational retirement provision (IORP II, COM/2014/0167 final), in which the Commission proposed to amend the IORP I directive to include, inter alia, the provision that "the institution shall ensure that prospective members are informed about all the features of the scheme and any investment options including information on how environmental, climate, social and corporate governance issues are considered in the investment approach" (art. 55).
- In March 2015, the European Commission proposed a new regulation with respect to a Union system for supply chain due diligence self-certification of responsible importers of tin, tantalum and tungsten, their ores, and gold originating in conflict ('conflict minerals') affected and high-risk areas (COM(2014) 111 final, 2014/0059 (COD)).

6. Internal governance and accountability of the institutional investor

6. a. To what extent can good internal governance of institutional investors, such as mechanisms aiming to align interests between beneficiaries, board and key executives, influence their ability and willingness to integrate ESG factors in investment decision-making and engage on these issues? Please provide evidence or good practices if possible.

Not applicable.

6. b. Do beneficiaries of pension funds and other institutional investors with long-term liabilities obtain sufficient and clear information about how the fund or investor is managing ESG risks? Can they give their opinion/be consulted on these aspects? Please provide examples of good practice.

Where investment funds are concerned, a fund always has fund documentation, often a prospectus, which describes the fund's investment beliefs and strategy, including whether or not it uses ESG investment beliefs and methods. This information is always publicly available and any prospective investor can read it before investing in that fund. Investors can get information on request.

Where discretionary portfolio management is concerned, the client can ask its asset manager to do ESG investing, and make as many detailed provisions as desired. This is at the discretion of the asset owner/institutional investor.

6. c. Are beneficiaries interested in matters referred to above? Please provide evidence if possible.

Yes, many beneficiaries are interested and interest in ESG is growing. This can be illustrated with the following data (which cannot be compared to each other, because different definitions and different scopes of research are used):

- The PRI initiative started with 73 signatories in May 2006 and had over 194 in May 2007. There were 814 signatories by October 2014, 226 of whom were asset owners and 588 were asset managers. As of April 2015, PRI's signatories represent $59 trillion of AuM, a 29% year-on-year

increase. According to PRI, this comprises just over half of the world's institutional assets. PRI now has nearly 1,400 signatories world-wide.

- A survey by KPMG and ALFI found that since 2012, in terms of RI, AuM in Europe increased by 56%, while the number of funds increased by 6%.[i]

- A Eurosif study[ii] finds that "all surveyed Sustainable and Responsible Investment Strategies are continuing to grow, in aggregate, with no exception, at a faster rate than the broad European asset management market". Some examples of growth rate between 2011 and 2013 include: sustainability themed – 22.6%, exclusions - 91%, impact investing – 132%. Eurosif notes that over this same period, the overall European asset management industry has grown by an estimated 22%. By the end of 2011, the RI market in Europe reached a total AuM exceeding EUR 6 trillion, up by 20% from 5 trillion by the end of 2009.

- According to the Global Sustainable Investment Alliance[iii], the global sustainable investment market has continued to grow both in absolute and relative terms, rising from US$ 13.3 trillion at the outset of 2012 to US$ 21.4 trillion at the start of 2014, and from 21.5 percent to 30.2 percent of the professionally managed assets in the regions covered. In Europe, RI grew from 49% to 58.8% of total AuM.[iv]

- According to the CFA Institute, almost three quarters of investment professionals world-wide take ESG issues into account in their investment decisions.[v]

7. <u>The role of other service providers</u>

7. a. Is there sufficient long-term oriented, reliable and relevant external investment research?

Quality of research has significantly improved over the last decade. There is still room for improvement, e.g. regarding comparability, however, market development is ongoing.

Are there barriers to good quality external investment research on ESG risks and opportunities? If so, please explain.

There are no major barriers to good quality external investment research on ESG risks and opportunities, however price may be an issue.

What role, if any, do financial incentives or conflicts of interests of some service providers play?

Financial resourcing is a key driver of the quality of teams' research providers are able to put together, and the quality of research they are able to produce.

A possible conflict of interest could be where a broker is working on an ESG research report which demonstrates poor industry-wide performance for a sector where a number of key clients come from.

7. b. To what extent do investment banks, investments analysts and brokers provide information on medium-to long-term company performance, including corporate governance and corporate sustainability factors, when they make buy, sell and hold recommendations to investors?

It depends on the broker but most of them understand the strategic aspect of ESG integration and have added this expertise to their services. There has been significant increased competition on the number of brokers providing research as well as the quality of research provided over the last 2-3 years. To re-iterate the point made above, it is important for these teams to continue getting the financial support for proper resourcing.

7. c. To what extent do investment consultants consider the asset managers' approach to ESG issues and active asset ownership when advising institutional investors about the selection of asset managers?

The main consultants systematically add ESG factors in their due diligence.

7. d. To what extent do proxy advisors consider medium-to long term performance of companies, including ESG performance, in their voting recommendations?

In their interactions with proxy advisors, some asset managers use custom voting policies whereby the proxy advisor implements the voting recommendations according to the manager's (ultimately the investor's) specific guidelines and philosophies. The asset manager can therefore make ESG performance part of its custom policy.

However, it should be noted that many managers use research and advice from proxy advisors as a source of information, which supplements their own in-house research. Some members will only use proxy advisory services for screening purposes, as a means of filtering important information. Therefore, whether or not proxy advisors consider ESG performance in their voting recommendations, is not a decisive causal factor in determining asset managers' voting in the companies they invest in.

It is also worth pointing out that asset managers, big and small, are required under UCITS and AIFMD to set up a voting policy and to report to their clients, including on the exercise of voting rights.

7. e. To what extent do credit rating agencies take medium-to long term performance of companies, including ESG performance, into account in their ratings?

We would suggest referring directly to answers provided by credit rating agencies.

7. f. What are the best practices as regards independent external assurance (for example auditor review) for the disclosure by companies of material medium- to long-term risks and opportunities, particularly ESG issues?

At a minimum, independent external assurances should provide confidence that:

- Control processes or risk assessment protocols are adequately designed to industry standard
- These processes are accomplishing the objectives it set out to achieve

8. The role of non-professional investors

8. a. Do you know of initiatives that led to more sustainable and responsible investment from non-professional investors? Please provide details about them.

ESG funds created by asset managers have mixed results (from a performance point of view) but generally speaking they have increased ESG investments among retail investors. Their success depends on market forces, for example whether the proposal appeals to the retail investor, and distribution power. It is generally difficult to convey the idea of RI products to retail investors as there is no clear and uniform understanding of RI. Also, retail investor attitudes to ESG investing are under researched. Until they are better understood, it is difficult to put forward effective measures to increase their participation in responsible investing. Research carried out by a Dutch polling company, I&O Research, concluded that while more than 80% of participants in Dutch pension funds oppose investing in companies who use child labour, armaments or tobacco (other exclusions have lower scores), 79% do not know whether their own pension funds actually execute certain exclusions. This specific research in one Member State highlights an apparent mismatch between investment beliefs and the information a retail investor will seek out in relation to the investment. However consumer attitudes need to be further researched, before we can put forward ideas on how best to stimulate retail investment in RI.

National labels intend to close this gap and there are several recent national initiatives such as LuxFlag, the FNG label in Germany or the government-backed label in France, however, the success of such labels can possibly only be evaluated within the next years.

Recently, Morningstar released its Sustainability Rating for Funds, which could potentially help promote responsible investing in funds, especially for retail investors.

In some Member States, there have been tax incentives, created by one government and abolished by another. These have often substantially increased interest among retail investors in ESG investing. Abolishing such tax incentives can lead to major outflows and thus major problems for investee companies. This is because ESG investments are sometimes illiquid (for example impact investments). Any public sector initiative needs to be at least as sustainable and long-term as the underlying investments.

9. Legal or regulatory constraints

9. a. Are there legal or regulatory constraints likely to significantly and unduly prevent or

discourage investors from taking a long-term view in their investment strategies and decisions and from investing in a sustainable way? If so, please provide details.

- Asset owners are often constrained by certain types of solvency rules and liquidity rules. The funds set aside to comply with solvency rules have to be invested and are often treated more favourably when they are more liquid. This is a constraint, given that not all ESG investing is in liquid investments.

- Asset owners tend to make discretionary portfolio management contracts with asset managers for a limited period – usually 3-5 years – and they require at least quarterly reporting on performance. As a result, asset managers often have to look at short term performance to keep their contracts. Similar to the current sentiment in respect of corporate behaviour, asset owners should also remain focused on their long-term goal, using shorter-term reporting from their asset managers as a demonstration of progress towards helping the asset owners achieve their goals.

9. b. Do you believe that there are any barriers to the understanding by institutional investors and asset managers of their fiduciary duties that would not enable them to appropriately take ESG factors into account in their investment decisions? Please explain.

No, we do not believe there are any such barriers.

The 2005 Report 'A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment' by legal firm Freshfields, commonly referred to as the 'Freshfields Report', was key in removing any barriers to understanding fiduciary duties of asset managers and institutional investors and ESG factors. The report sets out, inter alia, that ESG factors should be taken into account in investment decisions "where their integration accords with the best interests of the beneficiaries (established via implied or express consensus) or where they act as a point of differentiation among equally attractive investment alternatives".

The 2009 follow up report, by a group of UNEP FI asset managers, often referred as 'Freshfields II', further clarified that, where trustees integrate ESG issues into their decision-making, ESG should be embedded in the legal contract between asset owners and asset managers, with the implementation of this framework being governed by trustees via client reporting. Fiduciary II also makes a case for consultants having a duty to proactively raise ESG issues within their advisory process.

A joint report by UNEP FI, PRI, UN Global Compact and the UNEP Inquiry in 2015, based on interviews from 54 stakeholders –26 persons from 20 asset managers or pension funds, 14 people from 10 governmental organisations (mostly financial sector regulators), 11 law experts and 4 people from pressure groups –, found that a minority of the people interviewed were of the opinion that failing to consider long-term ESG issues in investment practice is a failure of fiduciary duty. Finally, a report by Ernst and Young Cleantech and Sustainability Services on behalf of the European Commission confirms that ESG integration is compatible with existing legal frameworks related to fiduciary duties in all jurisdictions across the EU.

10. Others

10. a. Are you aware of any other incentives or obstacle(s) with a significant impact? If so, which ones?

The main hurdle is the overall perception of the public that ESG investing is in general detrimental to performance (this includes retail investors who do select ESG investments). This flawed perception is spread widely enough to affect not only retail investors, but also Board members of institutional investors – who have fiduciary duties. It is not well known that empirical research overwhelmingly shows that ESG investing is at least neutral from a perspective of performance. Education therefore seems an appropriate tool to remove such hurdle.

Another obstacle is, in some cases, absorption capacity due to market conditions. In the green bond market, for instance, there is not enough green bond volume available to absorb the potential demand.

Financial resourcing can also be another obstacle, for the staffing required for multidisciplinary teams, as well as the technological solutions (for example, software development) needed for integration of ESG information into the investment platform.

Asset managers are increasingly realising that ESG factors can be integrated without lowering returns and ESG integration increases in practice. As a result, given client demand, asset managers are incentivised to explore the issue.

10. b. Would you consider further increase in sustainable investments if market or regulatory conditions for sustainable investment would be more favourable? If so, please provide estimations, if possible.

Asset managers will always serve their clients to the best of their ability. Therefore if clients/investors are looking for more ESG investment opportunities, asset managers will do their best to create them. Asset owners all over the world seem to increasingly consider taking ESG criteria into account in their investment policy. Regulatory requirements would make ESG investments a compliance issue and as a result the importance of the conviction of the positive effects of ESG investments would diminish.

You can upload additional documents here:

***

Brussels, 23 March 2016
[16-4008]

---

[i] KPMG (2015).
[ii] Eurosif, *European SRI Study 2014*.
[iii] *Global Sustainable Investment Review 2012* and *Global Sustainable Investment Review 2014*.
[iv] *Global Sustainable Investment Review 2014*, p. 7.
[v] *ESG issues in investing: investors debunk the myths*, CFA Institute, 28 October 2015.