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ESG risks : Towards green(er) pension investing? A pension supervisory approach

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ESG risks: towards greener pensions investing?

ESG factors and climate change in investment and risk management of pension funds

Role of IOPS in supporting ESG integration in pensions investment

Pension supervision of climate and environmental risks : challenges ahead

Relevance of ESG factors in long-term investment by pension funds

- The investments by pension funds are **long-term and are therefore exposed to longer-term risks**.
- ESG risks and opportunities include those related to **E**nvironmental issues (including climate change), **S**ocial issues, unsustainable business or unsound corporate **G**overnance practices.
- Most **ESG risks and opportunities have a long-term nature** and therefore are obviously relevant for long-term investors such as pension funds.
- In particular, **complex and difficult-to-predict effects of climate change and related regulatory responses** may have **a long-term character and may not be immediately and fully reflected in financial markets.**

? Question – how do pension funds access, choose and incorporate ESG opportunities?

Investment and risk management of pension funds
Past work

OECD/IOPS Good Practices for Pension Funds' Risk Management Systems (2011)

OECD/IOPS Good Practices on Pension Funds' Use of Alternative Instruments and Derivatives (2011)

OECD Core Principles of Private Pension Regulation (2016)
(investment and risk management process):

- Retirement income objective and prudential principles
- Prudent person standards (fiduciary standards and safeguards)
- Investment policy (objectives, process and review)
- Portfolio limits and other quantitative requirements
- Valuation of pension assets
- Performance assessment and monitoring procedure

IOPS WP29 Supervision of Pension Investment Management Including Non-traditional Investment (2017)

Investment and risk management of pension funds
Current work integrating ESG approach

OECD (2017), Investment governance and the integration of Environmental, Social and Governance factors

ESG issues addressed in IOPS Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds (2019)

Supervisory guidelines on the integration of ESG factors in the investment and risk management of pension funds (2019)

The IOPS ESG Guidelines are supervisory guidelines on the integration of ESG factors in the investment and risk management of pension funds	I. ESG factors in the investment and risk management process (4 guidelines)
	II. Integration of ESG factors in the investment and risk management process (2 guidelines)
	III. Disclosure of ESG factors in the investment and risk management process (3 guidelines)
	IV. Scenario testing of investment strategies (1 guideline)

The Guidelines are non-binding and are intended to provide guidance and serve as a reference point for supervisory authorities. As they are also largely principle-based, there is flexibility in how they are applied to account for differing pension system structures.

Key messages of the IOPS ESG Guidelines (1/2)

ESG consideration & integration

Supervisors should require that **pension funds consider ESG factors** in their investment and risk management process (G1) **with no prejudice** for the objective of obtaining an appropriate risk-return profile (G4), and **integrate ESG factors** in their investment and risk management process or **explain if otherwise** (G5) subject to the proportionality principle.

ESG & fiduciary duties

Supervisors should **clarify that integration of ESG factors** into investment and risk management process **is in line with fiduciary duty** (G2).

ESG & investment risks

Supervisors should require that **pension fund members are informed** of possible significant sacrifice of risk-adjusted returns in case of certain investment options based on non-financial factors (e.g. ethical investment) (G3).

ESG & disclosure on invest strategy

Supervisors should require **disclosure by pension funds on how:**

- they integrate ESG factors in their investments (G7);
- their investment policies treat long-term sustainability, including ESG factors, stewardship and non-financial factors. Potentially, funds should also report on their engagement with investees, and request companies in which they invest to disclose their ESG-related policies (G9).

Key messages of the IOPS ESG Guidelines (2/2)

ESG & regulation

Supervisors are encouraged **to provide some regulations, rules or guidance** to pension funds on how they should:

- analyse ESG risks when setting up investment policy (G6); and
- report to its members and stakeholders on substantial financial factors, including ESG factors (G8).

ESG & investment scenario

Supervisors should encourage pension funds to develop, appropriate **scenario testing** of its investment strategy; looking at all substantial financial factors, including ESG factors (G10).

ESG & resources

From the perspective of pension funds, **integration of ESG factors and provision of relevant disclosure can be challenging** because they require resources and expertise that might be available for large(r) funds only.

ESG integration approach

Finally yet importantly, the guidelines explicitly say that they do not intend to induce pension funds into ESG investments but to **require them to integrate ESG factors in investment and risk management processes.**

Climate and environmental risks as financial risks…

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Climate risks

- arising from climate change, including physical, transition and liability risks (APRA, 2021)
- posed by the exposure of financial institutions to physical or transition risks caused by or related to climate change (e.g. damage caused by extreme weather events, decline in asset value in carbon-intensive sector) (NGFS, 2020)

Environmental risks

- posed by the exposure of financial institutions and/or the financial sector to activities that may potentially cause or be affected by environmental degradation (such as air or water pollution, water pollution and scarcity of fresh water, land contamination and desertification, biodiversity loss, deforestation and the loss of ecosystem services (NGFS, 2020)

- **There is a connection and to some degree an overlap between climate-related and environmental risks.**
- **According to NGFS (2020), “supervisors have advanced most on assessing transition risks” but “more work needs to be done on identifying the financial risks stemming from environmental degradation”**

Climate risks can be drivers of prudential risk categories - some examples (NGFS, 2020)

Market risk	• Severe weather events or political measures (transition) → re-=pricing of financial instruments and corporate debts; • carbon tax → investment losses and lowered assets' values (stranded assets)
Operational risk	• Extreme weather event → business continuity • Financial institutions or their customers facing liability charges from parties who suffered losses from physical and transition effects
Underwriting risk	• Extreme weather events → higher than expected insurance claims
Liquidity risk	• a lack of reliable & comparable information on climate-sensitive exposures of financial institutions→ uncertainty, pro-cyclicality in the market, sell of carbon-intensive assets
Credit risk	• destruction of a production site by wildfire → increase in probability of default • new energy-efficiency standards → values of buildings provided as collateral decreases leading to loss from default of mortgage-backed loans

Climate and environmental risks
A focus on Pension Supervision –NGFS 2020

Supervisors to:

1. **determine risk channels** to economy/financial sectors and **identify how material** these risks are for supervised entities
2. **develop a clear strategy**, establish an **internal organisation** and allocate **resources** to address these risks
3. **identify the exposures** of supervised entities (including potential losses) – identify data gaps, data collection methods, methodologies (scenario analysis and stress testing), develop key micro risk indicators
4. **set up supervisory expectations** towards supervised entities with regard to these risks (governance, strategy, risk management, scenario analysis & stress testing, disclosure)
5. ensure supervised entities develop **adequate risk management** and take **mitigating actions** where appropriate

Climate and environmental risks : A focus on pension supervision (IOPS WP 2017)

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Same risk management framework but “the financial risks associated with climate change have a number of **elements that distinguish them from other financial risks** and necessitate a strategic approach to their management”:	the potential of **irreversible changes in climate** (not easily mitigated or reversed impacts)
	the **far-reaching impact on all parts of the financial system and risks** to manifest across multiple lines of business at the same time
	the **uncertain and extended time horizon** – might be beyond typical business planning cycles
	the **unprecedented nature of climate change** – historical data and back-ward-looking risk assessment methods unlikely to work proper

Scenario analysis/ stress testing

- it is prudent to develop such capabilities; proportionality, if small companies – narrative-driven scenario analysis

ESG investing – a journey…

Should not be a *hype*

- Intensive developments internationally and domestically taking place across all **E-S-G** should not be in vain..

Reliable data and transparency

- Avoid green washing
- Promote comparability and real impact

Good governance and risk management

- much longer time horizon perspective
- Involving training and guidance provided to supervised entities

A cultural change and learning process

- Address many challenges (e.g. costs & capacity issues fragmented approaches in ESG investing)

Need for international standards on sustainability disclosure

- **OECD** working on an ESG risk policy framework

Devil is in the details

- **IOPS** to :
  - work on implementation of its ESG guidelines
  - participate in various international organisations, including NGFS and IFRS

Thank You
Gracias!

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