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Re:
Sectoral letter on sustainable investments by pension funds: practical insights

Dear Members of the Board,

Over the past period, we have held talks with a number of pension funds and their asset managers that are leading the way in the field of sustainable investment. The focus in our discussions was on practical implementation. How can a pension fund safeguard the successful implementation of its sustainable investment policy? To advance the development of the pensions sector, we have prepared this sectoral letter to share some of the impressions we gained and lessons that can be learned. This could help pension funds learn from each other's experiences.

A sustainable investment policy takes into account environmental, social and governance factors[1] in a pension fund's decision-making aimed at strengthening risk management and achieving a sustainable long-term return on investment. We previously examined the state of affairs in the field of sustainable investment among Dutch pension funds in 2016.[2] This revealed that sustainable investment policies were rapidly gaining importance. Both the number of pension funds pursuing responsible investment strategies and the ways in which they do so were increasing. Pension funds were embedding sustainable investment more firmly throughout their organisations.

We believe it would be beneficial for Dutch pension funds to continue the upward trend by drafting or refining their sustainability policies. This will enable the sector to face the challenges posed by a sustainable world. Various initiatives have been taken in the sector to further sustainable investment, such as under the aegis of the Sustainable Finance Platform. We welcome such initiatives. Sustainable investment by pension funds is also a subject of attention internationally, witness the European Commission's Action Plan on Sustainable Finance and the attention devoted to the subject in the European Pensions Directive IORP II.[3]

The overall impression which we gained from our recent in-depth conversations about implementing sustainable investment policies is that there is no such thing as a one-size-fits-all approach. Nevertheless, a pension fund can take account of sustainability aspects in its investment policy while doing justice to its idiosyncratic features. Likewise, even though there is no template approach to sustainable investment, we did observe similarities that could contribute to successful

[1] Different phrases are used in practice to refer to the factors that make up sustainable or responsible investment. They are often referred to as environmental, social and governance (ESG) factors.
[2] See our report "Sustainable investment in the Dutch pension sector".
[3] This sectoral letter touches on subjects addressed in the IORP II Directive, but it must be seen as separate from it.

implementation. We have expressed these in the following four key messages, which are elaborated in the annex to this letter:

1. Be sure to have the support and commitment you need
2. Select an asset manager to suit your objectives
3. Make clear choices and collaborate
4. Get down to work!

We do not tell pension funds which choices to make with regard to sustainable investment. Pension funds have their own responsibility to decide to what extent they wish to pursue sustainable investment policies. Importantly, however, pension funds should make well-founded choices as to the approach that best suits their particular situation and stakeholders. This could apply to such aspects as exclusions, investor engagement, integrating sustainability factors in investment decisions, or the extent to which risks inherent in such factors are accepted. Naturally, we will oversee the sound implementation of investment policies.

Pursuing a sustainable investment policy will give you the opportunity to reaffirm your pension fund's identity and engage in a positive dialogue with pension scheme members and the wider outside world. It demonstrates how a pension fund can contribute to a more sustainable world, and it provides tools for addressing emerging risks. With this letter we aim to promote the further development of sustainable investment and encourage pension funds to start addressing the subject if they have not already done so.

Yours faithfully,
De Nederlandsche Bank N.V.

Gisella van Vollenhoven
Director, Pension Supervision Division

Annex to sectoral letter on sustainable investments by pension funds: practical insights

The talks we held with various pension funds and their asset managers revealed similarities that could contribute to the successful implementation of sustainable investment policies. We have expressed these in the following four key messages, which we elaborate below:

1. Be sure to have the support and commitment you need
2. Select an asset manager to suit your objectives
3. Make clear choices and collaborate
4. Get down to work!

1. Be sure to have the support and commitment you need

One of the insights we gained from our conversations is that it is important to devote a sufficient amount of time and attention to defining a shared set of objectives, principles and beliefs backed by all stakeholders.

Engaging in a stakeholder dialogue will help clarify the preferences of stakeholders and justify the choices made at board level. Such justification with regard to sustainability policy is not always easy. We have seen in practice that focus groups comprised of pension scheme members and pensioners are used for this. They enable nuances and dilemmas inherent in sustainable investment to be actively discussed.

A noticeable aspect is that choices with regard to sustainable investment are often related to the backgrounds of the stakeholders in a pension fund. Making choices that are closely related to the identity of a pension scheme's members, sector or employer can help muster support for the policy. For example, excluding investments in peer companies may be a sensitive issue that can be difficult to justify. Conversely, focused investments in sustainable initiatives that match a company's own activities may strengthen the bond with pension scheme members.

The extent to which a pension fund incorporates sustainability aspects into its investment policy is pre-eminently suited for discussion during the meetings in which a pension fund's board consults with other governance bodies to determine the objectives and policy principles.[4] Such meetings can help create support for the choices made with respect to a sustainable investment policy.

Justification has proven to be crucially important for a successful sustainable investment policy. It emerged from the talks we held that pension fund boards are well-advised to engage in an *ongoing* proactive and frequent dialogue on the policy pursued. It is virtually impossible to avoid dilemmas in the area of sustainable investment. Support can be preserved by explaining in advance the choices that will be made and how they fit the pension fund's policy. Of equal importance is that it should be explained why a pension fund opts to refrain

[4] See Section 102a of the Pensions Act.

from taking certain actions regarding its investments, and what steps it expects to take going forward.

Besides justifying choices with respect to policy and its implementation, it is important that account is rendered for the results achieved. Hence, for any sustainable investment policy to be effective, it is important that objectives – including long-term objectives – are set and results are measured, monitored and reported. Rendering account implies that policy choices are thoroughly substantiated and documented.

Linking measurable indicators to objectives makes results achieved quantifiable. Practice shows, however, that neither measurement instruments nor data have fully matured yet. Sometimes data are of poor quality or unavailable. We expect to see future improvements, however, given developments in reporting on non-financial information and impact indicators.[5] Standardisation will be useful in this respect. Joining forces and hooking up with ongoing initiatives eliminates the need for pension funds to reinvent the wheel.

Failing to provide adequate justification and render full account may result in reputation risk. It should be noted that reputation risk can never be fully excluded. Even if policies are transparent and well-considered, its results may fall short of the expectations harboured by the outside world. Outside parties could question choices that match a specific pension fund and its stakeholders.

Lastly, we have found board commitment to be a crucial success factor. This is because the tone at the top is very important. After all, a pension fund's board should communicate its policy and make sure that the changes needed are put into motion. Likewise, board commitment prevents a sustainability policy from being unduly called into question. Documenting a broadly supported sustainability policy on a long-term basis prevents ad-hoc decision-making, and it facilitates implementation and the rendering of account.

2. *Select an asset manager to suit your objectives*

Practice shows that the choice of asset manager – or fiduciary asset manager – in part determines the success of an investment policy. A sustainable investment policy cannot be considered separately from the asset manager or managers involved.

In drafting its sustainable investment policy, a pension fund could already consider the possibilities for implementing it. Are the objectives and the policy feasible, given the pension fund's characteristics and the investment opportunities available? Smaller pension funds may have fewer options for bespoke investment or may find specific complex asset classes less appropriate or have limited access to them.

This is not to say pension funds must base their sustainability policy on their asset managers. Many asset managers are also engaged in developing a sustainable investment policy. They might welcome close cooperation with their customers, which allows them to incorporate customer preferences into their product development. Some of the larger pension funds we talked to told us from their own experience that pension funds can sometimes steer asset

[5] Examples include the ongoing work of the FSB's Task Force on Climate-related Financial Disclosures and the Sustainable Finance Platform's Working Group on SDG Impact Measurement.

managers towards making their investment offering more sustainable. Defining specific objectives – including long-term objectives – will contribute to the successful embedding of sustainability in pension providers and changing their mindset concerning sustainable investment. Individually, smaller pension funds have less influence, but expressing their wishes and joining forces where appropriate will help them increase their clout. In consultation with an asset manager, they can discuss what results the latter is able and willing to achieve in the area of sustainable investment.

When selecting new asset managers, sustainability could be made part of the selection criteria. Defining such criteria in sufficient detail and providing clear instructions to possible consultants can help ensure that asset manager selection ties in with the sustainability policy. Minimum requirements could be set and areas specified in which the pension fund might be willing to moderate its demands. What we have seen is that considering sustainability criteria does not imply that any fundamental concessions are made in terms of risk and return.[6] What does happen, is that criteria are sometimes modified for pragmatic reasons, for example adjusting the investment universe. Similarly, shorter track records are accepted to capitalise on new sustainable investment opportunities.

Pension funds that participate in investment funds may find it difficult to select funds that are fully in line with the sustainability policy they wish to pursue. This will prevent the investment portfolio from fully reflecting a pension fund's sustainability policy. For this reason, a pension fund will be well-advised to determine upfront which concessions it might be willing to make in this respect. Again, it may be possible for a pension fund in consultation with the asset manager and other parties involved to steer matters in a certain direction.

Some providers of investment products prove unable to support their sustainability claims (greenwashing), which is why pension funds must ask themselves specific questions such as the following when selecting an asset manager. Does the investment portfolio effectively reflect the policy which a pension fund wishes to pursue? If this is not the case in all respects, can this be justified? How sustainable are the investments in actual fact? Does the asset manager's voting policy match the pension fund's sustainability objectives? Questions on "softer" aspects may also be of relevance. To what extent do key investment decision-makers support the sustainability policy? Is the degree of buy-in on the part of portfolio managers sufficient?

Be sure to have clear agreements with the asset managers on the sustainability policy in place, and maintain an open dialogue. Besides issuing instructions concerning the composition and management of portfolios to ensure they match the policy a pension fund wishes to pursue, it is important that agreements are made on information provision. After all, a pension fund's board should be able to account for its actions. For example, the board could ensure that reports address suitable indicators that are in line with the pension fund's objectives. However, there is more to rendering account for the policy pursued than number crunching. As choices with respect to sustainable investment are not always set in stone, it is important to keep in touch with the asset manager about the choices made, so that it can be clearly explained how sustainability

[6] This is in line with the Federation of the Dutch Pension Funds' Code of the Dutch Pension Funds and Service Document on Responsible Investment.

considerations inform investment decisions. It has proved to be useful to maintain an open dialogue with the asset managers on this subject. This allows for explanation not just according to the letter, but also in the spirit of the policy.

3. *Make clear choices and collaborate*

How a sustainable investment policy must be effected in practice will be different for each pension fund. We have found that the larger pension funds in particular tend to formulate comprehensive top-down sustainability objectives for their investment policies. Implementing such an approach in practice can be a daunting task, however. There is a wide array of potential strategies[7], as well as differences as to the extent to which they can be used with respect to asset classes and investment styles.

It is therefore important for pension funds to carefully consider what will work for them. This means that such aspects as investment beliefs, available capacity, expertise, degree of outsourcing, investment mix and costs must be looked at to determine suitable actions. Smaller pension funds in particular are likely in practice to face proportionality considerations. In the short term, setting up a fully integrated sustainable investment policy to cover their entire portfolio, including a framework for measuring and monitoring impacts may well be impractical for them. This does not need to keep them from pursuing a sustainable investment policy, however.

Focusing on low-hanging fruit will enable pension funds of limited resources to achieve good progress. This can be done, for example, by phasing in the policy in those parts of the investment portfolio that allow this with relative ease. Alternatively, a pension fund may wish to focus on those activities that have the largest impact.

A major pitfall is dividing attention among many different initiatives. There is a dazzling multitude of standards, principles, guidelines and partnerships that pension funds may wish to commit themselves to. In itself, endorsing them is a good thing, but it also brings responsibilities and takes up resources. So make deliberate choices in terms of the initiatives the pension fund opts to support. Half-hearted policy measures can result in reputation risk.

We have found that sustainability policies in practice tend to focus on asset classes. The ways in which a sustainable investment policy can be applied vary inherently among asset classes. For example, engagement can be applied to equity investments, although it is increasingly applied to fixed-income investments as well. In addition, the availability of data – for example carbon footprints – varies from one asset class to the other. Alternatively, considerations specific to a pension fund may be relevant. For example, while illiquid unlisted investments or active management may be effective from a sustainability viewpoint, they may be less suitable for other reasons. Feasible options must be considered for each asset class.

Some of the pension funds we talked to use their sustainability policies to specifically influence the parties they invest in, for example through their voting policies. Likewise, active engagement can be an effective strategy in this

[7] These include inclusion, exclusion, integration, voting policy, engagement and impact investing.

regard, although it is time-consuming. Creating focus can help reduce the burden and increase impact. Examples include limiting the number and duration of engagement processes, setting specific targets and working with other parties. We have seen this happen in practice. Joining forces helps pension funds increase their clout.

Overall, we have noticed the added value it brings pension funds to keep in touch with one another. Larger pension funds, in particular, tend to be more advanced in terms of developing sustainable investment strategies and methods. Sharing expertise and experience will enable pension funds to lean on each other. For example, large pension funds and their pension providers are making headway in allocating their investments to specific sustainability objectives. Seeking collaboration and hooking up with ongoing initiatives also allows pension funds to advance the creation of standards.

4. *Get down to work!*

Current thinking on sustainability is subject to change, and views differ as to which role pension funds should play in this area. That said, pension funds cannot escape the consequences of environmental, social and governance aspects on their investments. For example, investments in businesses that appear to violate human rights or are mismanaged can harm a pension fund's reputation. In addition, being long-term investors, pension funds face the ramifications of climate risks and the associated transition risks.[8] On the other hand, the transition to a more sustainable economy requires significant investment, creating opportunities for investors.

There is no ready-made solution for incorporating sustainability considerations into the investment process, and setting up a comprehensive policy cycle can prove difficult. Translating sustainability factors to an impact on risk and returns is work in progress, and limited availability of data and indicators complicates the designing of a sustainability policy.

However, this is no reason to disregard the subject altogether. Developing and implementing a sustainable investment policy is a step-by-step process. Waiting for the market to have fully matured means an opportunity lost and can make a pension fund vulnerable. We have found that sustainable investment is largely a matter of learning by doing. Getting down to work will enable a pension fund's own organisation, as well as the market as a whole, to achieve progress.

[8] For example, see our report "Waterproof? An exploration of climate-related risks for the Dutch financial sector."

Sustainable investment – the Pensions Act in outline

Pursuant to Section 135(4) of the Pensions Act, a pension fund must explain in its annual report how its investment policy takes account of the environment and climate change, human rights and social relations. This subject must be addressed in the management report, which is part of the annual report.

The law does not, however, impose any standards on the degree to which investments must be sustainable. Investment policies must be aimed at providing for best-possible pensions against acceptable risks and affordable prices.

In addition, Section 102a of the Pensions Act provides that a pension fund's board and the accountability body or stakeholder body must in mutual consultation ensure that objectives and policy principles, including the risk attitude, are documented. The question of whether and how a pension fund takes account of sustainability factors is pre-eminently suited for such consultations.

Furthermore, a sustainable investment policy must comply with the prudent person principle. One of the implications of this is that a pension fund's investments must be in the best interests of active and former members, and pensioners, as provided in Section 135(1)(a) of the Pensions Act. Pursuant to Section 143 of the Pensions Act, investments must be adequately managed. On a more general note, a pension fund's risk management must be adequate, as part of its sound and ethical operational management. Accordingly, risks inherent in environmental, social and governance factors must also be adequately managed.

The revised European Pension Directive IORP II, which will be transposed into Dutch legislation, explicitly devotes attention to sustainable investment. For example, it prescribes that pension funds must report transparently on how they take account of sustainability factors in their investment policy. The Directive also explicitly states that pension funds must include risks inherent in environmental, social and governance factors in their risk management and the newly introduced own-risk assessment. It does not oblige pension funds to ensure their investments are sustainable, however.

DeNederlandscheBank
EUROSYSTEEM

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The key messages in a nutshell			
<u>Be sure to have the support and commitment you need</u> *Shared principles* - Active dialogue - Matching stakeholders' backgrounds *Justification and rendering account* - Ongoing communication - Objectives, policy and indicators - Reports *Management commitment* - Tone at the top - Consistent policy	<u>Select an asset manager to suit your objectives</u> *Feasible targets* - Implementation must be practicable - Suitable for the pension fund *Collaboration* - Involve asset managers - Join forces *Selection* - Both hard and soft selection criteria - Be mindful of greenwashing *Agreements* - Investment guidelines - Provision of information - Letter and spirit of the policy	<u>Make clear choices and collaborate</u> *Appropriate policy implementation* - Proportionality - Make deliberate choices - Link with asset classes *Engagement and voting* - Focus - Collaborate	<u>Get down to work!</u> *Consequences cannot be escaped* - Risks and opportunities - Learning by doing