PensionsEurope's Position paper on the EU Sustainable Finance Strategy

July 2022

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Introduction

The EU Sustainable Finance Strategy was published by the European Commission on 6 July 2021. It is built on previous initiatives and reports, such as the report of the High-Level Expert Group on Sustainable Finance and the subsequent legislative package in 2018. Since then, pension funds have worked on implementing legislation under the Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation. The new EU Sustainable Finance strategy sets out how it will support the EU Green Deal and Europe's transition to becoming a carbon-neutral continent by 2050.

As the strategy notes, much has changed since 2018. New policy frontiers have emerged requiring further support – from the need to better finance the transition activities aligned with a more sustainable future, to the growing urgency to improve action on those issues. This paper presents the main positions of PensionsEurope on relevant topics and future initiatives.

Pension funds and the transition to a sustainable economy

The transition to an economy which allows a safe climate for all is one of the most important tasks for our generation. A wide range of policy initiatives is needed to pave the way for this transition. With regards to sustainable finance, pension funds can play their role in fostering the transition. Targeted policy initiatives on sustainability can complement ongoing initiatives within the financial sector.

PensionsEurope agrees with the European Commission that an inclusive economic transformation and recovery from the COVID pandemic requires massive amounts of finance. At the same time, climate and environmental risks are becoming more salient. The transition of the whole financial system is consequently extremely important.

By nature, pension funds are long-term investors that have as their main objective the delivery of adequate pensions to their members and beneficiaries. This means they should naturally take the long-term view and are required to consider the long-term risks that may affect their portfolios. ESG risks, and climate change risks, in particular, play an increasingly significant role in risk-management. In order to mitigate these risks, some pension funds have put in place carbon reduction plans or fossil fuel divestment policies. Moreover, there is a long tradition of pension funds aligning investment practices with the values of their members and beneficiaries and the needs of the society at large. Members are increasingly vocal about their sustainability preferences and pension funds are responding by increasing the level of ambition of their responsible investment policies.

The IORP II directive already requires IORPs to consider ESG risks and disclose information to current and prospective scheme members. The directive requires IORPs to invest assets following the prudent person principle, and it clarifies that taking ESG considerations into account is not in breach of this duty.

PensionsEurope supports the objectives of the Strategy

The new EU Sustainable Finance Strategy will support the EU Green Deal and Europe's transition to becoming a carbon-neutral continent by 2050 by:

- Financing the transition to sustainability and expanding coverage of the EU taxonomy.
- Building in inclusiveness with greater support for SMEs and individuals to access sustainable finance and participate in building a sustainable economy.
- Tackling the financial sector's resilience to sustainability risks and supporting its contribution to the transition towards a carbon-neutral continent.
- Playing a more active role in the global institutional infrastructure of sustainable finance.

PensionsEurope welcomes the ambitions and objectives of the strategy. We support the intention to propose legislation to support **financing the transition** of the broader economy, looking beyond activities that are already sustainable. Pension funds invest in a broad and diversified pool of assets and currently only a small part of the economy is already Paris-aligned. It is necessary to support realistic transition efforts across the whole economy.

In order to maintain support for the green transition, it is necessary that it remains an **inclusive transition**. As many pension funds are based on collective agreements and managed by the social partners, pension funds' responsible investment policies often place equivalent importance on social and environmental issues. PensionsEurope welcomes the ambition to raise the bar for reporting on social sustainability issues while recognising that social issues can be more context-specific and are harder to quantify.

As global investors, PensionsEurope also believes that **global efforts** are key to tackling the financial stability implications of climate risks. As a result, we support the European Commission's initiative to advocate at international forums and standard setters for developing global standards and principles for disclosure and agreeing on common objectives and principles for taxonomies.

Below, we have particularly focused on the key specific issues of the communication regarding pension funds.

Issue 1: *Double Materiality*

- *EIOPA to assess the need to review the fiduciary duties of pension funds to reflect sustainability impacts as part of investment decision making processes, including stewardship and engagement activities by 2022*

Fiduciary duties of IORPs and possible changes to the IORP II Directive:

Background

As part of the review of the IORP II directive, the European Commission plans to ask EIOPA to assess the need to review fiduciary duties (a) to reflect inside-out ESG risks including stewardship and (b) the potential need to broaden the concept of the "long-term best interest of members and beneficiaries".

Historically, there was a debate whether considering non-financial factors in investing was allowed under the fiduciary duty, particularly in common law countries. However, this debate has long been settled in courts and legislation. Article 19(1)b from the IORP II directive clarifies that IORPs shall be allowed to take account of ESG factors.

Moreover, more and more pension funds also consider the negative impact of investments on the environment and societies (inside-out perspective), in line with the OECD Guidelines. This means that they implement due diligence policies to identify and mitigate negative impacts. Also, impact investments, which are specifically targeted to achieve non-financial outcomes next to financial returns, are becoming increasingly popular investments amongst pension funds. PensionsEurope's members do not feel curtailed by the fiduciary duty as defined by IORP II in pursuing this inside-out perspective.

Considering the specificities of pension funds

The European Commission aims to increase the contribution of pension funds in the sustainability transition by reviewing the fiduciary duty. PensionsEurope understands that policymakers and society at large are increasing their expectations about pension funds' responsible investment policies. However, PensionsEurope urges that the review should take into consideration the specificities of pension funds.

In any possible scenario, we should make sure that the proposals are fit for the collective and mandatory setting of pension funds, which are very different from individual retail investment products. PensionsEurope is very concerned about the fact that strategy indicates that the framework for individual investment and insurance products should be developed 'in continuity' with the review of the fiduciary duties in IORP II. The situation where retail customer proactively selects an investment product that matches their preferences is fundamentally different from the collective investment setting of a pension fund. Simply copying regulations for retail financial services without regard to the specificities of pension funds will lead to poor regulation.

Considering the sustainability preferences of members and beneficiaries

The Strategy states that the review of the fiduciary duty should lead to the incorporation of sustainability preferences of members and beneficiaries. PensionsEurope believes that a number of considerations are relevant when translating this ambition into legislation.

- In IORPs, members and beneficiaries often are involved in the governance structure and the set-up of the investment policy. This means that the sustainability preferences of members are incorporated into the decision-making process.
- Most pension funds have a single investment policy that needs to accommodate all members and beneficiaries. This means that different views have to be translated into a single policy.

Furthermore, in many cases, employees have enrolled automatically, and they will never enrol through a financial adviser. These two elements of occupational pension funds keep costs well below personal pension products, leading to significantly better pension outcomes for members and participants. At the same time, this means that in most cases the member does not have an individual choice. It is not possible to copy the existing MiFID or IDD framework, which regulates how advisers should guide retail customers to individual products.

- It is important to consider who bears the investment risks: in a defined benefit pension scheme the sponsor company may be liable with all its assets for the pension promise and this could have an impact on the governance structure and role of the different stakeholders.

PensionsEurope cautions against a requirement for all IORPs to survey their members and beneficiaries regarding their sustainability preferences. Surveying some or even all members is very costly to the IORP – this will make occupational pensions more expensive and might be to the detriment of members and beneficiaries. These costs would be relatively speaking much higher for smaller IORPs. Therefore, we observe that mainly larger pension funds currently make use of membership surveys. In some jurisdictions, pension funds will already need to survey risk preferences, making the incorporation of sustainability preferences even more complicated.

Conclusion

Regulation should allow for sufficient flexibility for pension funds' boards to incorporate the relevant ESG and non-ESG considerations. It is highly important to reflect the representative structures of many IORPs in Europe whose boards represent social partners or members/beneficiaries and sponsors – for those IORPs, the decision-making process, in general, involves preferences including sustainability preferences of members by way of representation. Thus, this institutionalized collective way of covering individual preferences must be acknowledged. NCAs could be tasked with ensuring that this alternative method of incorporating preferences is adequately used.

Issue 2: *Extending the scope of the Taxonomy*

- *In 2022, the European Commission will publish a report describing the provisions required to cover economic activities that do not have a significant impact on environmental sustainability and economic activities that significantly harm environmental sustainability*

General remarks

The EU Taxonomy is an ambitious project to set common definitions for financial market participants on what economic activities are considered environmentally sustainable. PensionsEurope has supported the development of the Taxonomy, in particular by working with experts in the Platform on Sustainable Finance to arrive at science-based definitions. The implementation of the reporting requirements, however, has been very challenging due to lacking corporate reporting. This means that it will take still some time before reporting has fully matured. The strategy now argues that limiting the taxonomy to 'green' activities will not be effective in

making financial markets Paris-aligned because it does not encourage a move away from those activities that undermine the climate agreement. Therefore, an extension of the scope is required.

PensionsEurope believes that if the further development of the taxonomy follows the careful and consistent fashion in which the first delegated act on the green taxonomy was designed, based on scientific insights, it could provide investors and supervisors with a common framework for assessing transition paths, without having to develop own specific frameworks. Such a legitimized tool would stimulate standardization, potentially even beyond the EU. In order the be successful, the expanded taxonomy should align with current developments in legislation. This taxonomy could inform how financial institutions treat activities considered environmentally harmful in their exclusion policies, as well as encourage better disclosure of business activities outlined in the taxonomy. This could lead to more consistent data and support standardized screening approaches.

Broadening the scope of the Taxonomy

PensionsEurope supports broadening the scope of the taxonomy to include more sectors in the green taxonomy, sectors that play a role in the transition towards a more sustainable economy (amber), as well as sectors that do not have a significant impact on environmental sustainability (grey) and economic activities that significantly harm environmental sustainability (red). This should lead to a "general Taxonomy" that would provide more insight into the risk exposure of portfolios, allowing to better advise asset owners on their transition strategies.

Moreover, investors should be allowed time to carefully implement the broadened scope of the taxonomy, to be able to benefit from its potential and data, reported on a corporate level, should be allowed time to mature.

"Brown" taxonomy

PensionsEurope does not support a binary "green" versus "brown" divide. While a brown taxonomy would provide further indications concerning environmental risks, its development at this stage might produce negative consequences and prove challenging. First, it could be difficult to obtain data on harmful activities, as non-EU companies – representing a significant share of shares and corporate bonds – will not be inclined to voluntarily report on the share of these activities. A binary classification can also lead to formal or informal pressure to divest from these companies, even though these sectors will continue to play a role in the economy in the foreseeable future and need investments in order to improve their environmental impacts. Forcing European pension funds to divest from all economic activities could lead to a situation where their shareholders, on average, care less about sustainability than currently. Establishing realistic transition periods and targets for companies in environmentally harmful activities should be in coordination with EU transition funds to avoid sudden insolvencies and job losses, and EU regional policy should include more funds for the necessary reskilling of affected workers. If the taxonomy is aiming to help guide investors through the transition, it must be built to work dynamically, allowing it to evolve as the transition unfolds.

A "brown" taxonomy may also pave the way for tougher capital requirements for environmentally harmful activities concerning prudential purposes, known as a brown penalizing factor. PensionsEurope remains skeptical of the taxonomy as a basis for capital requirements. There needs to be strong evidence of how "green" support or "brown" penalizing factors contribute to financial stability before such measures should be adopted.

Issue 3: *Social Taxonomy*

- *After the publication of the final report by the Platform on Sustainable Finance, the European Commission is now expected to evaluate and proceed with a social taxonomy.*

The new strategy states that the Commission will publish a report on the provisions required for a social taxonomy, as required by the Taxonomy Regulation. The EC's Platform on Sustainable Finance already published its report on 28th February 2022 which will be used as a basis. The need for social investments to achieve the sustainable development goals (SDGs) on the 2030 Agenda, as well as to realize the social internal market envisaged in the Treaty on the European Union (Article 3), is widely recognized. So is the need to ensure that businesses show respect for human rights as envisaged in the UN Guiding Principles on Business and Human Rights (UNGPs). Fundamental EU documents, such as the European Pillar of Social Rights and the associated action plan, the European Social Charter, the EU Charter on Fundamental Rights and the European Convention on Human Rights, provide strong foundations and inspiration for a social taxonomy.

A social taxonomy would be both vertical and horizontal, with the vertical dimension focusing on products and services for basic human needs and basic infrastructure. From this perspective, economic activities that make these products and services more accessible, while not harming efforts to achieve other social objectives, could be considered social. The horizontal dimension considers impacts on different groups of stakeholders affected by economic activities – workers, including value chain workers, consumers and communities. Horizontal objectives would be likely to include a combination of entity- and activity-level criteria, crucial for ensuring businesses' respect and support for human rights as part of the social taxonomy.

PensionsEurope emphasizes the following major challenges regarding social taxonomy:

- PensionsEurope believes that a balance in the relationship between an environmental and a social taxonomy needs to be ensured. One suggestion is that just as social and governance-related minimum safeguards (UNGPs and OECD guidelines on multinationals) are part of the environmental taxonomy, minimum environmental safeguards should be part of the social taxonomy, for example along the lines of the environmental part of the OECD guidelines.

- The development of the social taxonomy is also relevant to Sustainable Finance Disclosure Regulation (SFDR). PensionsEurope believes that the implementation of the SFDR should be finished before the introduction of the Social Taxonomy. The main question is whether social issues should be separated or part of the same taxonomy and disclosure requirements as the

environmental issues. Some pension funds want to keep social issues separate as otherwise there is a threat that the investee companies will not disclose the required data for the pension fund to claim that they have an Article 9 product. This issue may limit pension funds' possibilities to diversify their investment in the global markets and limiting the investment universe may be harmful.

- The social taxonomy should focus on usability. Data is more challenging for social sustainability compared to environmental issues. The social taxonomy should focus on issues where data is available, or can become available, for example through the CSRD.

- PensionsEurope recognizes the fact that while the green taxonomy is based on science, the new social taxonomy will be based on international norms and universal principles. For this reason, it can be very difficult to develop meaningful quantitative criteria. Reporting requirements should be developed and interpreted with these considerations in mind.

Issue 4: *SFDR*

The implementation of the SFDR has been challenging for pension funds so far, in particular, due to unclear definitions, a regulation that is targeted at retail investors rather than members and beneficiaries, as well as the lack of ESG data. The delay in Level 2, the delayed and incomplete guidance by NCAs and ESAs on important questions, have further exacerbated the situation. The implementation phase will continue to last until the first reporting of principle adverse impacts ("PAI") in June 2023. Finetuning the implementation will take even more time. Nevertheless, the European Commission is already considering amendments.

Sustainable investment

An important outstanding issue in the implementation phase is the definition of "sustainable investments". There is currently no guidance on the interpretation of the definition, which is relevant both for the classification of Article 9 products, as well as the reporting of the share of sustainable investment by Article 8 products. As a result, there is a serious risk of diverging implementation practices and a lack of comparability between products and reporting.

Minimum requirements

The announced proposals of the EU Commission for minimum standards for sustainable products according to Article 8, Disclosure Regulation is of relevance. This is intended to clarify minimum requirements to ensure sustainability aspects of such products. We are in favor to have a well-defined materiality threshold for Art. 8 to make sure that the SFRD does not lead to a regulatory-driven "greenwashing" because too many products with too low ESG standards are being driven to be labelled sustainable products according to the SFDR. However, In the case of the IORP sector, the ESAs

were previously keen to widen the scope of Art. 8, by defining the notion of 'promotion' as much as possible. This desire was based on the SFDR's core idea that, by forcing more disclosures, consumers and members would have more information and this would lead to more capital being managed under responsible investment strategies. However, it seems questionable that the unclear definitions and likely very legalistic and technical information in the SFDR templates will indeed lead to a better understanding by consumers. This conclusion was corroborated by the consumer testing conducted in the Netherlands and Poland. Therefore, it seems that the ESAs and the European Commission have now concluded that the SFDR rather functions as a label and therefore minimum requirements are needed. While this may be needed to achieve the policy outcomes envisaged, it should be acknowledged that this is a shift and at odds with the earlier desire to define the scope of Article 8 as wide as possible. PensionsEurope believes it is undesirable that pension funds would declassify as Article 8, for fear of being accused of greenwashing. The fact of the matter is that for many IORPs that the question is still not answered precisely where an Art. 8 product begins. Further clarification through Q&As is welcome.

Principal adverse impacts

Concerning Art. 4 and 7 SFDR and the publication of the PAI statement including the indicators for the principal adverse impact, the ESA's indicated the wish to revise and clarify those indicators related to climate and environment as well as those related to social and human rights.

PensionsEurope urges the European Commission to first allow for the full implementation of the existing SFDR rules, including the Regulatory Technical Standards. Full PAI reporting will not happen until 2023 and financial market participants have to implement the reporting templates. The Commission should assess the effectiveness of the information requirements, as well as the availability and quality of corporate ESG data, before adding further levels of complexity. Financial market participants are required to collect data on the current set of indicators from the beginning of 2022 (given the latest announcements of the European Commission to apply the SFDR delegated acts from 1st Jan 2023 but to collect data already for 2022). As such, future changes to the indicators to collect should be made only after a thorough assessment and after some years of collecting the current set of data.

The European Commission also plans to initiate that for all "conventional" financial products under SFDR (thus "Art. 6 products) financial market participants should publish decarbonization measures and also their effectiveness. This would mean more far-reaching concrete information requirements and not only for sustainable financial products according to Art. 8 and 9. We think that it does make sense to assess the effect and quality of disclosure requirements for sustainable products before expanding the scope of obligatory information for all products.

Issue 5: *Non-Financial Reporting and Accounting Standards*

- *EFRAG will prepare a simplified voluntary sustainability reporting standard in line with CSRD*

Under Article 19b (1) of the European Commission's proposal for a Corporate Sustainability Reporting Directive (CSRD), EFRAG was mandated by the European Commission to develop draft EU sustainability reporting standards. On 29 April 2022, EFRAG published a public consultation on the Draft European Sustainability Reporting Standards (ESRS) Exposure Drafts (EDs) developed by the EFRAG project task force. In those Draft European Sustainability Reporting Standards (ESRS) presented by EFRAG, private pensions are not directly considered a benefit for employees.
PensionsEurope emphasizes the need to better recognize private pensions, which will be open to all company's workforce, as an indicator of a good remuneration policy.

On 3 November 2021, the IFRS Foundation Trustees announced the creation of a new standard-setting board—the International Sustainability Standards Board (ISSB). The ISSB has published a consultation on the Exposure Draft IFRS S2 Climate-related Disclosures (Climate Exposure Draft) builds upon the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) and incorporates industry-based disclosure requirements.

Ideally, the development of the ESG reporting internationally and at all levels of the economy should be done to fulfil the existing data gap for investors. For this reason, the European Commission expressed in the strategy its intention to work with the European Financial Reporting Advisory Group (EFRAG), the European Securities and Markets Authority (ESMA) and the International Accounting Standards Board (IASB) to assess whether international financial reporting standards (IFRS) appropriately integrate sustainability risks.

PensionsEurope emphasizes the following major issues regarding reporting standards:

The current fragmentation is confusing and complex. There are multiple sustainability reporting standards such as GRI, SASB, TCFD and others that are implemented differently in different jurisdictions. As a result, there is an immediate need to ameliorate the consistency and comparability of sustainability reporting.

Broadening the scope of the IFRS to include non-financial / sustainable reporting standards is a step in the right direction both from the perspective of international companies as well as pension funds. Considering that the IFRS sets international accounting and reporting standards, this can ensure comparability in this area between different jurisdictions.

Moreover, consistency between the Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR) on the one hand and the Corporate Sustainability Reporting Directive and the future sustainable reporting standards on the other is crucial for financial entities. The main reason is the fact that the SFRD introduces reporting requirements on principal adverse impacts (PAIs) along with a broad set of 18 quantitative and qualitative indicators. Therefore, the financial sector essentially is required to report on information that does not yet need to be made public by companies. This means

that pension funds will need to obtain information, partly based on estimates, from specialized data providers. As a result, data sets can diverge significantly and come at a significant cost.

Issue 6: *Financial literacy*

- *The European Commission together with the OECD published their joint financial competence frameworks for adults and young people reflecting the skills and knowledge individuals need to support their financial well-being and to further access sustainable finance.*

On ESG and financial literacy, PensionsEurope shares the European Commission's position that it is important to encourage greater retail investor engagement by seeking improvements in the level of sustainability expertise of advisors and further integrating sustainability considerations in financial literacy frameworks. In the EU financial literacy framework, a specific section (2.6 p. 268) is included emphasising the need to take into account sustainability considerations for pensions. There is a need of educating people by providing them from early stages (i.e., from schools) with the right set of skills and knowledge that allows an individual to make informed and effective decisions, and of raising awareness of the importance of saving for retirement. Collective and mandatory systems do address challenges with lack of financial literacy, as the decision of how to save for pensions and decumulate are made for individuals.

Finally, the use of technology and innovative solutions to engage members, e.g., digital interactions with members via innovative awareness solutions using artificial intelligence is important to improve the financial literacy of the public.

Issue 7: Systemic risks

- *Take action to ensure that relevant ESG risks are systematically captured in credit ratings and rating outlooks in a transparent manner, considering further assessment by ESMA (2023)*

The European Commission expresses the view that managing systemic risks requires appropriate tools from macroprudential authorities. For this reason, the EC's strategy states that further work will be conducted on broadening the scope to non-banking sectors and environmental risks based on advice by the European Supervisory Authorities and the ECB. The ability of pension funds, financial institutions, and investors to manage and absorb financial losses arising from sustainability risks is key for financial stability and the resilience of the real economy during the transition. It is important that pension funds will have the necessary resources to finance the transition and respond to investment opportunities. Safeguarding financial stability and facilitating sustainable growth thus have to be balanced. Moreover, we believe that any future climate stress test should be integrated into the normal stress testing exercise to avoid duplications and the use of extra resources in the exercise.

Issue 8: *ESG DATA*

- *Activation of the ESAP and the Open Finance Framework*

Robust, comparable, and reliable ESG data is necessary for identifying and assessing sustainability risks and key for enabling pension funds to steer their portfolios towards sustainability objectives. Pension funds increasingly want to incorporate sustainability considerations in investments but at times face data constraints, as data is not always available or is only available at a significant cost. The European Commission expresses the ambition that EU initiatives, such as including sustainability-related information in the European Single Access Point (ESAP) and the Open Finance Framework, will help to unleash this potential. We in general support the development of the European Single Access Point (ESAP) and the Open Finance Framework to give better access to sustainability-related information. ESAP includes the principle that all information that has to be published according to EU law (more than 35 EU directives and regulations) must be included in the ESAP starting from 2025. Also, IORPs are directly affected and have to feed in their published information. We would like to emphasize that the focus in the first place should be indeed on the area of sustainability-related information of investee companies also regarding ESAP. The ESAP initiative could address these challenges, in combination with an ambitious review of the Corporate Sustainability Reporting Directive. Once the ESAP is up and running, it could be extended to other areas. This will best serve for robust, comparable, and reliable ESG data that is necessary for identifying and assessing sustainability risks and key for enabling pension funds to steer their portfolios towards sustainability objectives.

In general, to make informed investment decisions, pension funds rely for the moment on several data providers, which represents a significant cost, especially for small entities. The companies' public information is normally dispersed over several sources and few companies disclose, for instance, non-financial information. Those companies that public sustainability reports do not do it in a standardized way, which makes the analysis and treatment of information very difficult and burdensome. The cost for gathering and using companies' public information depends on the fee policy of data providers and how many data providers are needed to obtain all the necessary data. Often, the direct costs are not very high (the data is available) but indirect costs (e.g., those related to processing, validating, and using the data) can be very significant. As a result, the necessary regulation and supervision of data providers need to be addressed by the EU institutions.