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CONSULTATION RESPONSE

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SUBJECT: Response to EC consultation on long-term and sustainable investment

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Response to the European Commission's public consultation on long-term and sustainable investment

General remarks

Pension funds' primary objective is to provide a retirement income to its participants and beneficiaries. The protection of participants is inherent to that goal. Investments are an essential part of pension provision: historically, around three quarter of the realised pension benefits at retirement age resulted from return on investments.

As not-for-profit social institutions, pension funds are investors with a long-term investment horizon, as they need to secure sufficient benefits for current and future pensioners. Pension funds seek to invest in assets with long and stable cash flows, ideally linked to inflation, that match their long-term liabilities. This long investment horizon allows them to invest in asset classes that are not accessible to short-term investors, such as illiquid, private assets or asset classes with high start-up costs.

Our members, Dutch pension funds, recognise that with their long-term horizons, Responsible Investment is an important issue and embedded in finding a balance between risk and return on investments. Pension funds' boards and participants alike believe that a good retirement should be enjoyed in a world that is worth living in, for current and future generations to come.

Dutch pension funds' responsible investment policies are based on the norms and values of their participants and board members, i.e. employers and employees. The variety of types of funds, e.g. industry-wide, professional or company pension funds, leads to a large diversity in our industry. As a result of that diversity, Responsible Investment policies are equally diverse.

- European initiatives or regulation should take into account the characteristics of pension funds as institutional investors in order to stimulate investments and turn the EU into a smart, sustainable and inclusive economy delivering high levels of employment, productivity and social cohesion. Striking the right balance between risk, return, complexity and costs is of the essence for pension funds. To be able to do so, pension funds should retain their freedom of investment, as to adhere to their own investment beliefs and policies. Only then can they achieve their core objective: to provide adequate pensions at relatively low costs.

The Federation's initiatives related to Responsible Investment

The topic of Responsible Investment has received increasing attention from pension funds over the years. Pension funds choose their own investment policies and develop their own views on Responsible Investment. At the industry-level, the Federation has undertaken a few initiatives:

In 2003, a first assessment of pension funds' policies for responsible investment was made. Back then, a quarter of the participating industry-wide pension funds and one in ten company pension funds had formulated an explicit policy. In April 2007, the Dutch pension funds established a committee to develop recommendations on responsible investment. This guidance was then presented in the report "De gearriveerde toekomst"[1], which translates to "The future has arrived." Ever since, an increasing number of pension funds has formulated and implemented a policy on responsible investment. Many pension funds provide information to their participants and beneficiaries about how they think about and carry out responsible investments.

In 2013, we had a look at responsible investment again. By then, more than 80% of the participating industry-wide pension funds, two-third of the participating company pension funds, and three quarters of the professional pension funds had a policy for responsible investment in place. The funds that had not yet developed such a policy tended to be the smaller funds. These funds did not have an explicit policy, but generally made indirect use of the responsible

[1] 'De gearriveerde toekomst - Nederlandse pensioenfondsen en de praktijk van verantwoord beleggen ', Vereniging van Bedrijfstakpensioenfondsen, Stichting voor Ondernemingspensioenfondsen, Unie van Beroepspensioenfondsen, 2007.
http://www.pensioenfederatie.nl/services/publicaties/Pages/De_gearriveerde_toekomst_Nederlandse_pensioenfondsen_en_de_praktijk_van_verantwoord_beleggen_17.aspx?source=/services/publicaties/servicedocumenten/pages/default.aspx

investment policies of their asset managers. Almost all Dutch pension funds are a signatory, directly or indirectly through their asset manager, of the UN Principles of Responsible Investment (PRI). The Dutch signatories of the UNPRI can be found here.

Currently, we are working on a service document on Responsible Investment (forthcoming May 2016) for our members. This document aims to offer guidance to those of our members who want to (further) develop a vision and policy on responsible investment, and offers guidance in how to implement, monitor and evaluate these policies. It does not judge on what responsible investments entail or not.

For our previous contributions related to the Capital Markets Union, Long Term Financing and the Call for Evidence, please consult our responses:

- Federation response to Green paper on Long-Term Financing of the European Economy (2013)
- Federation response to the CMU consultation (2015)
- Position paper on CMU
- Federation response to the Call for Evidence consultation

About the Federation of the Dutch Pension Funds

On behalf of about 250 pension funds, the Federation of the Dutch Pension Funds (the Federation) promotes the pension interests of 5.6 million active participants, 2.9 million pensioners and 8.3 million early leavers. About 80% of the total number of Dutch employees is participant of a pension fund that is associated with the Federation.

The members of the Federation have around 1200 billion euro of assets under management. Most of the Dutch pension funds have outsourced their administration and asset management to service providers.

Consultation response

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?*

Because of their long investment horizon, pension funds (and other long-term investors) need to consider and prepare for scenarios that may seem unlikely in the short run, but with potentially negative consequences in the long run, both for their participants and beneficiaries and their portfolios. They consider it only good risk management to incorporate sustainability factors. The incorporation of ESG criteria is an integral part of the investment beliefs of Dutch pension funds. Social returns are not a substitute for financial returns, but many funds express an ambition to generate social returns without compromising financial returns. That is why investment opportunities that address major challenges for society, such as climate change, are increasingly sought after. Therefore, we believe quality, in addition to quantity, of investments should be the EU's main focus, to avoid excessive short-termism and to attract committed long-term investors.

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As active owners, pension funds engage with their investees in order to create added value: long-term investments should be "engaged capital". As shareholders and (co-) owners of the businesses they invest in, pension funds recognise their rights and responsibilities. They believe that engagement should apply to the entire investment cycle, and include non-financial factors. An adequate functioning and cross-border voting chain enables investors and shareholders to hold their investees to account. In developing and maintaining both long-term investment strategies and relationships between investors and shareholders, we also support the Model Mandate developed by the International Corporate Governance Network (ICGN).[2]

Eumedion, the Dutch corporate governance forum, has defined 10 best practices on engaged share-ownership for institutional investors, that many of our members support and adhere to. The document can be found on [Eumedion's website](#).

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.

Pension fund governance has long been an important topic of discussion within the Dutch industry. In 2005, the Labour Foundation in cooperation with the Dutch pension fund industry published the Principles of Good Pension Fund Governance, which provided guidelines to help pension funds improve their accountability to stakeholders and internal supervisory arrangements.

Code of the Dutch Pension Funds[3]

The Code of the Dutch Pension Funds sets the standards for good pension fund governance in The Netherlands. It entered into force in 2014 and covers themes such as integral risk management, remuneration, diversity and sustainable investment. In addition, the Code includes recommendations regarding arrangements for the appointment, dismissal and terms of office of trustees and members of other bodies.

With regard to responsible investment, of which ESG integration forms a part, three norms have been established:

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[2] Available online: https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/SHREC/ICGN_Model_Mandate_2012_re-printApr2013_FULL.pdf

[3] Available online: http://www.pensioenfederatie.nl/services/publicaties/Pages/Code_of_the_Dutch_Pension_Funds_72.aspx

27. The board of trustees will lay down its considerations concerning sustainable investments and ensure these are available to stakeholders. In this regard, the board will also take account of good corporate governance.

Clarification

On the basis of article 135, subsection 4, of the Pensions Act, the Board of Trustees is responsible for ensuring the investment policy includes an explanation of how the fund takes account of the environment and climate, human rights and social relationships. In addition – within the framework of the corporate governance code – it is also appropriate for pension funds as investors to promote good corporate governance in the undertakings in which they invest.

28. In determining its policy, the board of trustees will take account of the fund's liabilities. In addition, account must also be taken of its responsibilities vis- à- vis stakeholders to ensure an optimal return at an acceptable level of risk.

29. The board of trustees must ensure that the stakeholders support the choices being made regarding sustainable investment.

Clarification

Regarding the sustainable investment policy, it is essential that support is created through dialogue with the VO or BO.

Explanatory note:

VO stands for verantwoordingsorgaan, the accountability body; BO stands for belanghebbendenorgaan, the stakeholders' body.

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.

Information provision by pension funds

The Code of Dutch Pension Funds is embedded in the law. The Dutch government did so at the request of the Federation and the Labour Foundation. The Code's legal embedding entered into force on 1 July 2014. The Code includes norms concerning Responsible Investment, which have therefore become legal obligations for Dutch pension funds. As a result, the Dutch pension fund industry is the only industry with industry-wide provisions around Responsible Investment.

On the same date of 1 July 2014, an additional provision about ***reporting*** was added to the Pension Act and the Occupational Pension Scheme (Obligatory Membership) Act [*Wet verplichte beroepspensioenregeling*]. It requires pension funds to explain in its annual report how the investment policy includes an explanation of how the fund takes account of the environment and climate, human rights and social relationships.[4]

The pension fund boards are allowed to fulfil these norms at their own discretion. In practice, the different practices reflect the diversity found within our industry. Some of the very large pension funds choose to report on Responsible Investment in a separate annual report, with an explanation of their rationale. For many of the smaller funds, such information is part of their annual report.

[4] Article 135(4) Pension Act, and article 130(4) Occupational Pension Scheme (Obligatory Membership) Act.

Examples of good practice from our industry

Please note that we have only chosen to highlight a few good examples. These reports are in English and therefore easier to refer to in the context of this consultation. Many more good examples can be found in the Dutch pension industry, and the Federation is always prepared to help the European Commission in finding more information.

1. **PMT** has a Strategic investment framework for 2015-2020 in English, available through its specific web page on the investment policy.
2. **PGGM** Responsible Investment Report 2014 reported on behalf of PFZW, more information to be found on the PFZW website on the topic.
3. **ABP** Responsible Investment Report 2014
4. An example of information provision aimed specifically at participants is a brochure from **PFZW/PGGM**, about their sustainable investments, in Dutch: https://www.pfzw.nl/Documents/Over-ons/verantwoord-beleggen/Korte-brochure-duurzaam-beleggen.pdf

Influence of participants

The influence of participants is embedded in the law as well, and depending on the governance model of the pension fund, as explained below.

A pension fund with an independent board model or a one-tier board (mixed) model will have a stakeholders' body (*belanghebbendenorgaan, BO*). The stakeholders' body secures that their interests are taken into account, and it has the explicit legal right to approve of the board's adoption or changes to the strategic investment policy. The law also specifies that the stakeholders' body may advise the board on matters concerning the pension fund. This could therefore also be matters related to ESG inclusion, or responsible investment in general. An example is also the outsourcing agreement with an asset manager.

In a pension fund with a paritarian board/paritarian mixed board model or inverse mixed model, stakeholders are represented within the board itself, and therefore share the responsibilities for the funds' policies. In such a case, the

- board is held accountable to the accountability body (*verantwoordingsorgaan, VO*) with regard to its policies and implementation.

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.

Regulation regarding pensions as well as financial markets should foster, or at least not discourage, (sustainable) long-term investments. As for pension funds regulation, supervisory frameworks should therefore allow sufficient room for pension funds to invest in illiquid assets. Supervision imposes short-term constraints on pension funds through solvency and liquidity requirements. This does not always correspond to the long-term nature of pension fund liabilities. Therefore, we believe supervision and regulation should take into account the balance between risks and long-term returns.

Pension funds face financial regulations (such as for instance EMIR, MiFID II) that are not conducive to holding long-term assets, since they are often based on a "one size fits all" principle. A 'one-size-fits-all' approach ignores important differences between markets and market players. The relevant characteristics are that Dutch pension funds have long-term investment horizons, the fact that they are capital funded, and are not leveraged. This gives them a relatively low risk profile compared to other financial market players. At the national level as well, prudential regulation may restrict asset allocation to long-term investment categories. Risk-calibrations, capital requirements and financial regulation have an impact on pension funds' long term investment horizon.

Minimum solvency requirements in European or national legislation may have a pro-cyclical effect, particularly in current circumstances where solvency rates are close to or even below their minimum levels. A decline in asset prices results in a further drop in solvency rates, which may trigger forced asset sales if supervisors force pension funds to de-risk their portfolios. As a result, pension funds are not always able to hold their long-term investment for as long as previously intended. The prospect of potential forces sales may discourage long-term investments.

- In order to be able to make investments into e.g. renewable energy and infrastructure, a stable and clear policy framework is essential.[5] We therefore support the work of the Institutional Investors Group on Climate Change (IIGCC) and actively engage with policy makers. The European Commission could play an important role in the support and promotion of existing standards for assessing the sustainability and governance performance in different asset classes such as real estate (such as the GRESB[6] does), and could encourage efforts to build a common standard for infrastructure assets. This would enable pension funds to assess the ESG-performance and related risks of their investments. Moreover, the European Commission could consider supporting recent developments in corporate reporting, such as the provision of integrated accounting, in which is shown how businesses create and sustain value.

Financial Transaction Tax

The proposed FTT as discussed in the enhanced cooperation of EU member states (FTT-10) would give rise to inconsistencies and unintended consequences in legislation. The FTT has a “cascading” effect; along each intermediate transaction (step) before a bond, equity or derivatives reaches the end user, tax has to be paid. This increases the price of the securities affected by FTT disproportionately. A system, in which a market participant can retrospectively collect their paid FTT tax from the member state that has levied it, is disputable. Experience proves that it will take months, or even years to get tax reimbursements. The fact that this tax money cannot be invested during the reimbursement period reduces the budget for long-term investment. A potential FTT on derivatives, combined with EMIR, would discourage their use for risk management by pension funds. If left unaddressed, effective risk management by end-users of financial markets will be more difficult.

EMIR (Clearing House and Clearing Members Margins and Collateral Requirements)

Pension funds currently use OTC derivatives to mitigate risks, such as interest rate risk or foreign currency risk. The OTC derivatives portfolios used for this

[5] Some of our proposed solutions can be found in our response to the CMU consultation, on page 4-5, and 14-15.

[6] GRESB provides a sustainability performance benchmark of real estate portfolios (public, private and direct) around the globe. https://www.gresb.com/

purpose are very sizeable relative to the pension fund's investment portfolio. The Variation Margin (VM) required for OTC derivatives could be posted in high quality bonds before the introduction of EMIR. Under EMIR CCPs only accept cash as VM, even though EMIR itself doesn't require this. Moreover, an additional Initial Margin is introduced which is restricted to be in high quality bonds or cash. Both cause strong increase in (collateral) requirements compared to the current OTC market for derivatives. The result is high liquidity risks for pension funds, especially in stressed scenarios. Fire sales of (liquid) assets in stressed scenarios are probable to meet the margin requirements. In order to avoid "default" in crisis scenarios pension funds need to hold (uncomfortably) large cash-buffers. This consequence of EMIR is not to the benefit of pension fund members.

Pension funds aim to be fully invested and do not want to hold significant amounts of cash. In addition, cash nowadays has mostly negative interest rates and is therefore a drain on the pension scheme instead of an addition. Holding large cash reserves reduces the available budget for long-term investing.

Several Dutch, British and Danish pension providers have addressed the current issues around pension funds and central clearing in a position paper.[7]

SME investments

There are several areas where current regulations are causing inefficiency and may deter (long-term) investments to (cross-border) SME investments. The two most prominent of these are:

- National insolvency legislation. Large differences in national procedures and rulings may make some member states an unattractive destination for SME financing.
- A lack of common reporting standards for non-listed companies.

[7] Available online: https://www.pggm.nl/wat-vinden-we/Documents/pggm-position-paper-european-market-infrastructure-regulation-(emir)_13-08-2015.pdf

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.

Tomorrow's risks are not sufficiently included in yesterday's data. The calibration of risk models is therefore more difficult, and leaves some asset owners concerned that ESG integration may result in lower returns on investments – especially in the short term.

10. Others

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

The horizon of an institution is typically longer than that of its employees. Incentives should be geared towards bringing the horizon of individual employees more in line with that of the organisation, for instance through long-term performance targets.

Traditionally, asset managers are used to think in terms of asset classes, and less so in societal themes. New risks, on the other hand, tend to affect multiple asset classes, to a meta-level.

A good industry initiative with potential positive impact comes from the Focusing Capital on the Long Term initiative. The FCLT has published a long-term portfolio guide for institutional investors, that provides recommendations on core areas through which institutional investors are able to create long-term value and improve their outcomes.

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.

Yes. In our response to the Capital Markets Union consultation we highlighted some market and regulatory conditions we consider to be helpful or unhelpful in expanding our consideration of long-term and sustainable investments. However, precise estimates are difficult to provide.