IORPs’ fiduciary duty in light of sustainability considerations

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Good morning, and thanks to EIOPA for the opportunity to address this conference. There is a lot going on, and it is good to have the opportunity to have a discussion about these important issues.

My objective is to look at the challenges created for those running IORPs (I will call them managers) when they are allowed or required to take account of sustainability considerations.

It is important that I start with a disclaimer. As you may know, EIOPA is working on a response to the EU Commission’s call for advice related to a review of the IORP II Directive, and sustainability is one of the topics raised in the call for advice. No decisions have been made about EIOPA’s response, and what I say here this morning represents a personal, not an EIOPA view.

Some EU legislation defines “sustainability” as the whole range of environmental, social and governance issues, but I will focus more on environmental and especially climate issues. However, I think that the points I make have a wider application to ESG matters as well.

I am going to identify what I see as some of the practical challenges and problems created by applying sustainability considerations into the fiduciary management of IORPs. However, it is important to say that this is not intended to be an argument against including sustainability. Rather, we need to identify and try to resolve these challenges in order to achieve our objectives. It is very important to bear in mind that, although there are a number of very large IORPs, most IORPs are small or medium with limited resources. Therefore issues which are challenging enough for the financial services industry are especially difficult for many IORPs. This needs to be borne in mind throughout this discussion.

Let me start with a definition. What I mean by sustainability considerations is not just explicitly incorporating financially material climate and environmental factors into investment analysis. In my view, this falls within the definition of fiduciary duty in any case. What I am addressing is double materiality – in other words taking account also of the costs and benefits of the climate or environmental externalities created by the assets in which the IORP invests.

I am making two assumptions:

(a) The first assumption is that incorporating double materiality considerations increases the risk of a lower return.

It is a risk, not a certainty: it is possible that future events mean that such a portfolio will not result in lower returns, for instance in the event of high carbon pricing or a disorderly transition leading to carbon assets becoming stranded, or an accelerated energy transition which increases the value of renewable energy. But these are optimistic scenarios, and we must recognise that sustainability considerations in investment may result in lower returns.

(b) The second assumption is that sustainability considerations are not a simple yes or no decision: managers must decide to what extent they take the considerations into account and also what kind of approach to take.

Even without sustainability considerations, fiduciary duty has always been a very demanding obligation. Fiduciary duty arises when someone has responsibility for making financial decisions on behalf of someone else. Because the future cannot be known, it is not possible to create a set of rules that can be mechanically applied in all circumstances. Fiduciary duty is therefore a framework or a set of principles within which managers are required to apply their judgement.

Actually, fiduciary duty requires that the managers make two judgements – what is the best interest of members and beneficiaries, and what actions would best achieve that.

It is a responsibility that is and was demanding in itself long before we started to think about sustainability considerations.

The issue is not necessarily that fiduciary duty is at odds with sustainability. Any potential conflict can and should be addressed through clear legislation, which lifts the uncertainty from the managers. No, this is a complexity and information problem far more than a legal issue. The problem is that fiduciary duty is a challenging responsibility and that sustainability considerations make it even more challenging than it already is.

Managers already have the responsibility of deciding the appropriate balance between risk and returns. This is a familiar problem, although that does not mean that it is easy. Sustainability considerations add a third and possibly even a fourth dimension to this responsibility.

The two challenges of sustainability considerations for managers of IORPs are how to decide the 'right amount' of sustainability considerations and, having decided, how to achieve it. The challenge for those who supervise IORPs is to assess how well they are doing.

In the first place, managers need to decide how much sustainability is 'enough'. Is there such a thing as too much? There probably is. There is certainly for many people such a thing as too little. But we also have to recognise that there is no simplistic measure of sustainability, but rather there are a range of possible targets, considerations and ways of thinking about sustainability, which are not necessarily compatible with each other.

One possibility is to ask members. But

- How well do they understand the possible trade-offs?
- Was the answer dependent on how the question was asked?
- What if they don't answer? What if only some of them answer?
- Did different classes of members give different answers?

Unless legislation is very prescriptive, and I don't see how it can be, managers will have to use their own judgement about the extent of sustainability or the target they set. Of course, fiduciary duty always involves judgement, but the issue of sustainability is new, unfamiliar and changing territory for most if not all managers.

Once the decision about the degree of sustainability is made, it is a considerable challenge to give effect to it. There is no common reliable measure or rating, or single framework for action.

Managers must decide where to direct their investments, based on some (hopefully) coherent model for how this will contribute to sustainability goals. And within their chosen model, they will need information to translate goals into meaningful practice.

Applying sustainability considerations requires judgement. Judgement has to be based on reliable useable information. Furthermore, IORP managers cannot simply decide what information they want and then expect to find it easily in the market. All but the very largest IORPs are information takers: they have to work with what information the (investment) market provides. Making sure that such reliable, meaningful and usable information is available must be a priority for legislators.

Of particular concern is model risk. There are considerable differences between the sustainability ratings of the different ratings bodies. In one way, this is a good thing, because it reflects the differences in opinion and methodology that exist: we are not seeing a false consensus. However, if IORP managers and other investors are going to rely on these sustainability ratings, the ratings are going to have a considerable impact on the investment allocation of IORPs, based on what are fundamentally subjective views of the relative sustainability credentials of different assets. If there are only a small number of ratings available, these subjective judgements will have significant influence on markets. If there are a large number of differing ratings, it will be very difficult for managers to choose among them, and the choice they make will have a significant impact on their investment decisions.

After the financial crisis, there was understandable concern about over-reliance on credit rating agencies. We need to find a way to avoid similar issues relating to sustainability.

But IORP managers have to choose and rely on one or more of these ratings. It is not going to be easy to make that decision.

Many of these issues exist because applying sustainability considerations to investment at scale is still very new – we have very little knowledge, experience or data. But we do not have the luxury of time to address them.

There is considerable amount of work being done to address these issues by many organisations at many levels. They include governments, regulators and international bodies, academics, NGOs, international networks and initiatives drawing on different kinds of commercial and technical experience.

This means that there are resources for managers to draw on, but they must identify ones that are appropriate for them, and this is itself a significant challenge. They also need to accept that models and best practice are likely to change over time.

The most important point that I want to make is that all obligations imposed on IORPs must be examined from the perspective of those who have to apply them. We should not underestimate the complexity of their task. It is relatively easy to articulate principles that have broad support and which are aligned with worthwhile objectives. What must not be overlooked is the question of how they can be applied in practice. Are they too vague? Are they aspirational rather than practical? Are they measurable?

At the same time, we do not want to tell managers that they should wait until every challenge has been fully ironed out before taking action.

In all this, regulators and supervisors face the familiar challenge of protecting members and beneficiaries without being too prescriptive, stifling innovation or distorting behaviour. At the same time, we can play our part in supporting IORP managers to play their part in advancing sustainability goals.

Let me summarise in the following two points:

1. The questions that managers need to answer in order to apply sustainability considerations within the framework of fiduciary duty are how much, how to do it, what information to rely on, and how to deal with the changes and developments that will inevitably happen.

2. The questions that legislators need to answer in order to apply sustainability considerations are how can they implement a practical system that takes account of the real world challenges that I have just set out.

In 1970 the famous Chicago economist Milton Friedman wrote an article in the New York Times which was to define an era. His proposition that the only purpose of business is to make profit elevated the concept of shareholder value as the dominant consideration for investors and managers. The advantage of such a view was that it simplified business decisions. The problem was that it ignored environmental and social costs, the so-called externalities.

That era is now over, but to paraphrase Antonio Gramsci, quite what will replace it has not yet been determined. There are challenging times ahead.