Inquiry: Design of a Sustainable Financial System

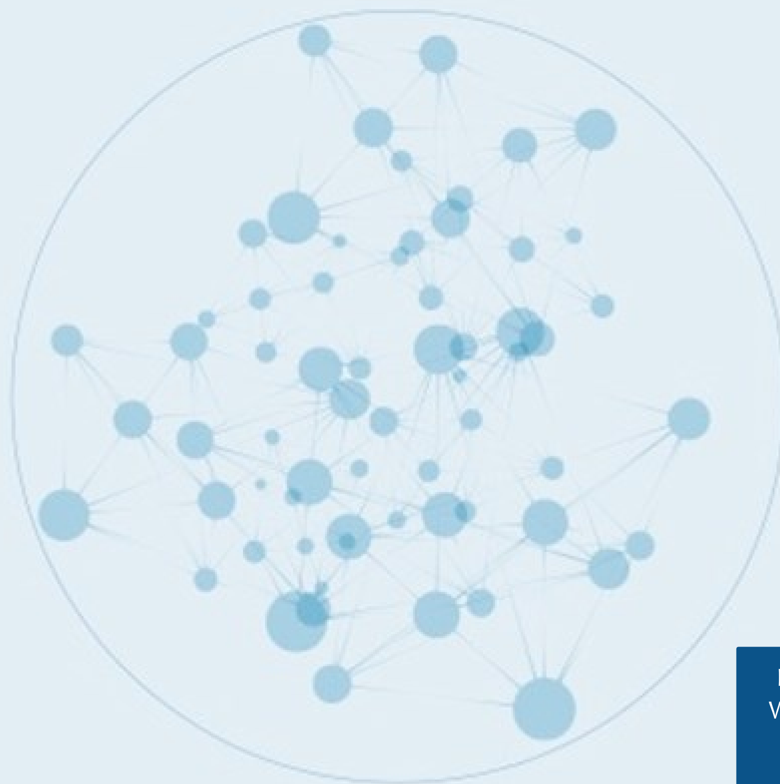
CalPERS

Rob Lake Advisors Ltd.

UNEP

FINANCIAL REFORM, INSTITUTIONAL INVESTORS AND SUSTAINABLE DEVELOPMENT

A review of current policy initiatives and proposals for further progress



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The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it will publish its final report in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

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For more than eight decades, CalPERS has built retirement and health security for State, school, and public agency members who invest their lifework in public service. CalPERS is a long-term investor and committed to sustainable investments, as outlined in its investment beliefs. CalPERS' total fund market value currently stands at approximately $287 billion. Its pension fund serves more than 1.7 million members in the CalPERS retirement system and administers benefits for more than 1.4 million members and their families in its health program, making it the largest defined-benefit public pension in the US. For more information, visit *www.calpers.ca.gov*.

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About this report

This paper provides perspectives and proposals on the relationship between institutional investors and sustainable development. It builds on a Discussion Paper prepared for a workshop hosted by the inquiry and CalPERS in June 2015 and incorporates issues raised at that event.

Comments are welcome and should be sent to Nick Robins, Co-Director of the Inquiry (*nick.robins@unep.org*) or Rob Lake (*rob.lake@roblakeadvisors.co.uk*).

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Foreword

CalPERS is delighted to support the work of the UNEP Inquiry both through our Chief Executive Anne Stausboll's membership in its Advisory Council and through our particular encouragement for its work on behalf of institutional investors. As one of the world's largest investors, we have long been convinced of the need to think in terms of sustainability. Our institution needs to be sustainable in order to deliver the commitments on pension and health benefits we have made to our beneficiaries. This means our investment returns need to be sustainable. This in turn means the companies we invest in need to operate in a sustainable way. And this means the economy, the environment and the society on which they depend must be sustainable too.

This focus on sustainability is reflected in CalPERS' governance. Our Investment Beliefs, which form the framework for the strategic management of our portfolio, stress the importance of the environment and human capital for long-term sustainable value creation, and the need for us to consider risks such as climate change and natural resource scarcity as we make our investment decisions. Our board and staff work hard to ensure that our Investment Beliefs are brought to life in our day-to-day work, and woven into our relationships with our partners along the investment chain.

At CalPERS we have no doubt that our focus on sustainability is entirely consistent with our fiduciary duty – indeed it is an essential part of it. Where doubts on this score remain, they must be dispelled. And we need institutions that have the knowledge, the skills and the ways of working that are required to embed sustainability in their investments – to manage the risks it brings, and to capitalize upon the opportunities if offers. We hope every country will reflect on how it can best address these challenges.

Much more needs to be done to encourage and enable investors around the world to give sustainability the importance it deserves. Different countries have different ways of doing things, so the details will vary from place to place. However, this report highlights the need for the legal frameworks to be right, and for the institutions to be right, if we are to combine delivering healthy long-term investment returns with a healthy environment and a healthy society.

Of all the sustainability challenges we face, climate change is one of the most pressing. This report is being published just a few weeks before the Paris Climate Change Conference. At CalPERS, we earnestly hope the world's governments will reach an ambitious global agreement to address climate change. Bold action is needed in particular to introduce stable, reliable and economically meaningful carbon pricing, and to strengthen regulatory support for clean energy. This will enable us, as investors, to manage the risks and take the opportunities that climate change brings.

This report is an important contribution to the efforts that CalPERS and investors and governments around the world are undertaking to make the objective of the Inquiry – a sustainable financial system – a reality. We look forward to working with our fellow investors, with governments and regulators and with other interested parties to continue these efforts.

Henry Jones, Chair of Investment Committee, CalPERS

Messages and Executive Summary

Policy reform is critical for aligning institutional investors with sustainable development. Relying on voluntary action and enlightened self-interest by investors will not be sufficient to achieve sustainability goals. Proactive policy intervention is needed both in the real economy and within the financial system.

Sustainability demands a systemic, dynamic policy approach. Previous interventions to promote the environmental and social dimension of investment have focused principally on disclosure of policies and formal statements of legal duties. They have largely taken fundamental features of the design and operation of the financial system as given. The need now is for a more systemic and dynamic approach – an approach that builds institutional investment frameworks, investment institutions and an investment culture with sustainability at their core. Policy interventions that directly address institutional investors also need to be set in the broader context of action relating to the financial system as a whole – including financialization and accounting standards.

Interventions focusing on sustainability and investment intersect with other pressing policy objectives. These include tackling climate change, long-termism, post-crisis economic recovery, securing retirement incomes for ageing populations, meeting energy, water and food needs, and public trust in the financial system. Policy can support existing market initiatives and fill the gap where markets will not deliver solutions.

Seven critical policy objectives hold the strongest potential for positive change: aligning institutional investment system design with sustainability; removing policy barriers; stimulating demand for investment that integrates sustainability; strengthening asset owner governance and capabilities; lengthening investment horizons; aligning incentives along the investment chain; and ensuring investor accountability.

Fourteen policy tools can help get us there: the design of pension systems; investment performance measurement; the legal duties of investment institutions; the legal duties of the directors of risk-taking financial institutions; solvency and risk regulations; prudential regulation; investor disclosure rules; corporate disclosure rules; fiscal incentives; rules on equity and credit research; investor rights, codes and stewardship; risk mitigation and market development for green assets; soft law sustainability frameworks; and professional qualifications and knowledge transfer.

In recent years, policymakers have pursued a wide range of objectives through interventions directed at institutional investors: protecting savers' financial interests, competitiveness, consumer protection, general economic welfare, social responsibility, protecting national reputation, and channelling capital to national policy priorities. In parallel, investors have built policies and organizational processes focused on environmental, social and governance (ESG) issues, and developed new tools to incorporate them into investment decisions.

This first generation of policy intervention – which has occurred mainly in developed markets – has focused largely on disclosure obligations and on statements on investors' core legal duties. Signs are now emerging of a second generation approach that is more dynamic, addressing not just "what", but "how". In many areas there is a strong synergy between sustainability and other policy objectives – including improving prudential regulation to protect retirement incomes and ensure financial stability,

regenerating the real economy, and strengthening public trust in the financial system. Many ongoing trends with positive sustainability potential – such as efforts to strengthen asset owner governance and promote long-termism – are not driven principally by sustainability goals; however, they can make substantial contributions to them. A significant opportunity exists to maximize benefits in multiple areas by making the connections among policy objectives explicit.

At the same time, certain features of the high-level context within which institutional investors operate continue to undermine sustainability objectives. For example, defined contribution (DC) pension systems that encourage high levels of member choice may encourage investment strategies that focus on short-term performance to avoid the risk of losing members. More broadly still, the phenomenon of financialization pressurizes companies to give primacy to short-term financial performance, weakening countervailing signals from long-term investors who give greater weight to sustainable development.

To secure alignment between institutional investors and sustainable development, policy should pursue seven overarching **objectives**:

- **Align system design with sustainability:** the structure of pension systems in particular can create conditions that favour or discourage sustainability and long-term investment – as well as having differential outcomes for pension savers.
- **Remove barriers** in existing policy that hamper the integration of sustainability into the investment chain – e.g. in relation to investors' legal duties, solvency and risk management.
- **Stimulate demand** for investment strategies, advice, asset management, research and corporate disclosure that incorporate sustainability. Asset owners, as the principals in the investment chain, are the primary source of demand. Their requirements and expectations will shape what other parties supply.
- **Strengthen governance and capabilities**: Well-governed investment institutions, most notably asset owners, with strong capabilities and an understanding of the implications of sustainable development for their core mission and purpose, are well placed to develop investment beliefs and strategies aligned with sustainability. They will generate demand for services from other parties in the investment chain that reflect sustainability. They will also be able to exercise more effective stewardship over companies and markets.
- **Lengthen investment horizons:** Investors who take a longer-term perspective are likely to attach greater weight to sustainability. Short-termism is driven by powerful psychological and behavioural factors that shape organizational and industry-wide incentives, structures, tools and cultures.
- **Align incentives:** All participants in the investment chain need incentives that focus on the appropriate balance between long- and short-term financial objectives, in ways that take account of sustainability. This requires appropriate benchmarks, performance monitoring directed towards long-term value creation rather than short-term risk, well-designed asset manager fees and pay, and executive remuneration at investee companies based on long-term performance metrics and sustainability.
- **Ensure accountability:** Investors with strong accountability to beneficiaries, customers and society at large will be attuned to stakeholders' mounting sustainability concerns and will have strong incentives to incorporate sustainability into their operations.

The extent of market failures in relation to sustainability suggests that using a wide range of policy measures is justified. Policy actions will need to strike the appropriate balance between the interests of investors and wider social and sustainability objectives. We have identified suitable **policy tools** in 14 key areas.

- *Pension system design*

Pension systems should be designed to strike the optimum balance among adequacy and reliability of outcomes for savers (e.g. protection against large market movements that affect retirement incomes), affordability for public and private sector sponsors, and sustainable development (e.g. promoting long-term investment and allocation to illiquid assets). Allowing high levels of consumer choice and switching in DC funds may reduce long-term investment.

Existing examples: New DC pension models are being developed (e.g. in the Netherlands and the UK) that may offer these features. Some existing defined benefit (DB) funds have strong commitments to sustainability.

- *Performance measurement*

The performance of institutional investment should be measured and reported by investors in terms not just of financial metrics, but also of environmental and social outcomes. Government should support the development of appropriate measurement and reporting frameworks.

Existing example: Carbon footprint reporting.

- *Legal duties – institutions*

Policymakers in all jurisdictions should ensure that definitions and interpretations of fiduciary duty and prudent investment enable and encourage investors to take account of financially relevant ESG issues and to focus on long-term performance and risk. The removal of quantitative investment restrictions and the introduction of the prudent person principle is an opportunity to align new rules with sustainability.

Existing examples: South Africa, UK.

Governments should give public sector pension funds, sovereign wealth funds and other state investment institutions formal sustainability obligations.

Existing example: Government Pension Fund Global, Norway; AP funds, Sweden.

- *Legal duties – individuals*

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