Sustainable investment in the Dutch pension sector

DeNederlandscheBank

EUROSYSTEEM

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Foreword

Towards sustainable prosperity

DNB seeks to safeguard financial stability and thus contributes to sustainable prosperity in the Netherlands. That prosperity should also be tenable in the long run, which means future generations must also benefit. To achieve this lasting objective, we at De Nederlandsche Bank are working together with the pension sector.

We have recently carried out a study into one of these aspects: sustainable investment. This is an area of growing importance. In fact, for some years now, pension funds have been required by law to be transparent about this in their annual report. We are pleased with this development, as this level of transparency stimulates dialogue. Openness and dialogue are paramount in stimulating a balanced consideration of interests concerning pensions.

This dialogue begins in the pension fund boardroom, not with us. We are not concerned with the nature of the fund and the policy decisions. We do however consider the consequences of these decisions and as the supervisory authority, we of course emphasise the importance of a balanced and sustainable investment policy, with respect to the risks and opportunities. This is because it strengthens financial sector stability and contributes to sustainable prosperity.

Our study has revealed that the Dutch pensions sector has in recent years made considerable progress and made conscious choices in terms of sustainable investment. A number of players lead the field in this respect, and also enjoy a notable reputation internationally. In addition to the major players, there are also smaller funds in the vanguard, which is encouraging to see.

We play a coordinating and catalysing role in increasing the sustainability of the financial sector. We would therefore like to share the insights we have gained into the pension sector in the past year. Our focus is not limited to pensions funds; our findings may also inspire banks and insurers.

One of our initiatives aimed at fostering such cross-fertilisation has been to launch a cross-sectoral platform for sustainable finance. From this platform, we will work together with the pension, banking and insurance sectors to provide a positive impulse and see how we can prevent or overcome any obstacles.

It is our responsibility to work together to make our financial system future-proof. This will allow us in the sector to make an effective contribution to sustainable prosperity. For all generations.

Frank Elderson
Director, Supervision of Pensions, De Nederlandsche Bank

Summary

Sustainable investment is a hot topic. Sustainable investment is increasing among pension funds, as are the various strategies for incorporating sustainability in their investment policy. As a result, sustainable investment is becoming more embedded in organisations.

We have recently carried out research into the status of sustainable investment in the pension sector and have discussed the issue with experts and other interested parties such as scientists, asset managers, NGOs and special-interest groups. We have looked at what developments are underway now and which ones are expected to occur in future.

This report firstly outlines the status of the pension sector. Based on the developments we observed, we then looked to see whether there were any specific issues relating to bolstering sustainability. These could include bottlenecks, but we have also looked specifically at those areas where we have identified scope for positive impulses that can be given to sustainable investment.

During the study we also formulated follow-up actions for the sustainable investment chain.

Five follow-up actions

For pension funds (and their managers):

1. Strengthen cooperation within the sector
2. Focus on making sustainable investment more transparent
3. Embed sustainability further in risk management policies for the investment portfolio

For the entire sustainable investment chain:

4. Improve the availability, quality and standardisation of ESG[1] information and aim for unambiguous sustainability reports
5. Conduct further scientific research and studies into the effects of ESG factors on investment policies

These points for action are further described in section 4.

1 ESG means Environmental, Social and Governance, three key criteria for measuring the sustainability of investments.

1 Introduction

Sustainability is an area of growing importance in the financial sector. This happens in various ways in the pension sector, and is receiving increasing attention. It is clear that in recent years this subject has become more deeply embedded and integrated as a core task of pension funds: fund management. The coming years will see sustainable investment remain high on the sector's agenda, and knowledge, implementation and data processing will develop further.

Awareness of the impact of investment has grown in recent years, and as a result the subject has climbed the pension sector's agenda. An increasingly recurring question was how pension funds can make investments that are as sustainable as possible. This led to another question, namely: what is sustainable investment.

The study we have conducted in the last few months highlights the fact that sustainable investment in the Dutch pensions sector continues to be highly relevant.

We looked at how the Dutch pensions sector makes sustainable investments, the developments underway and which are expected. We have also looked at pension funds' transparency regarding their efforts and results. During the study we also formulated follow-up actions to gain a tighter hold on sustainable investment and to increase transparency.

Each investment fund decides for itself on how to interpret sustainability, in a way that fits with the objectives and the principles of the fund and its participants.

Our key observations are set out in the following sections.

- Section 2 sketches sector developments in the area of sustainable development
- Section 3 describes how sustainable investment at pension funds are realised
- Section 4 discusses the follow-up steps to arrive at a sustainable approach

2 Status of the sector

What developments do we see?

In recent years Dutch pension funds have interpreted their sustainability policy in various ways. The investment choices they make vary, as well as the intensity with which they implement the investment policy. In this section we outline the status of sustainable investment in the sector.

Pension funds and sustainable investment in 2015

Five categories of sustainable investment, broken down according to intensity	Types of sustainable investment under this category	Number of funds in this category
Funds included in the report which have no or no clear data about their sustainability policy.	■ Not known, no explanation in the annual report	27 (12%)
Funds that have a limited sustainability policy.	■ No established CSR policy ■ No consistent application of principles ■ Limited exclusion policy	67 (31%)
Funds that have an active sustainability policy and integrate ESG factors in investment policy. Policy is implemented partly through passive management.	■ More or less established CSR policy ■ Application of principles ■ Exclusion policy ■ Engagement ■ Voting (shareholder meetings) ■ Best-in-class selection	57 (26%)
Funds that have a more intensive sustainability policy, in which the implementation also involves active management and in certain cases ongoing consideration of sustainability choices.	■ More far-reaching CSR policy ■ Application of principles ■ Exclusion policy ■ Engagement ■ Voting (shareholder meetings) ■ Best-in-class selection	43 (20%)

Funds that have an integrated sustainability policy, implementing sustainability in the various phases of the policy process. They take proactive action to achieve objectives and communicate openly about their efforts and results.	■ Integrated CSR policy, focusing on specific themes ■ Application of principles ■ Exclusion policy ■ Engagement ■ Voting (shareholder meetings) ■ Best-in-class selection ■ Impact investing ■ Committed to cooperation within the sector ■ CSR reports	25 (11%)

Source: annual reports, websites and accounting documents issued by pension funds, 2013-2015

We compiled this table on the basis of the pension funds' policy documents. Pension funds are currently rolling out their policies, and their targets and milestones vary. This means most funds find it difficult to quantify the share of their sustainable investments, with a few exceptions. For example, ABP, the pension fund for employees in the government and education sectors, which is the largest pension fund in the Netherlands, achieved around 10% in sustainable investment as at 30 June 2016.

Sustainable investment by number of participants and invested assets

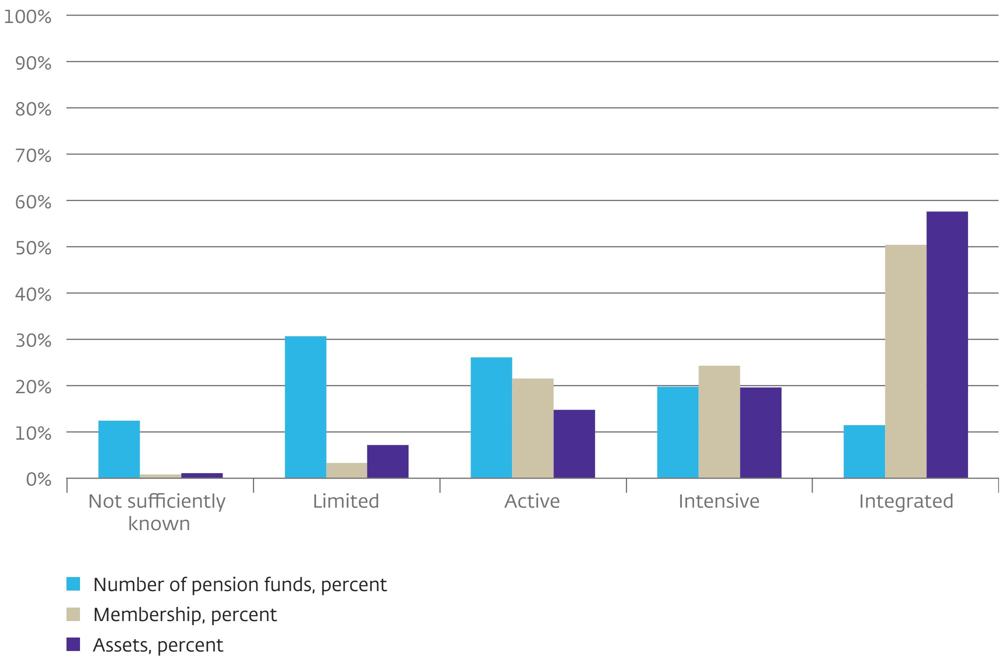
In total we have looked at the details of 219 pension funds in the Netherlands. We have also compared the number of funds per category with the number of pension fund members and invested capital. From the comparison it is clear that in 2015:

- Half of the total number of pension fund members accrue pension rights with funds that pursue a reasonably integrated sustainability policy. Together, these funds manage 58% of total pension assets.
- Almost a quarter of pension fund members belong to a pension fund that pursues a more intensive sustainability policy. Together, these funds manage around 20% of total pension assets.
- Over 20% of members belong to a pension fund with an active sustainability policy (15% of total pension assets).
- Just 5% of members accrue pension rights with funds where the details are not known, or which have a limited sustainability policy. Together, these funds manage 8% of total pension assets.

The data clearly show that it is mainly the larger funds which make sustainable investments.

Chart 1 The 219 pension funds, by numbers, by membership and by assets

In percentages



Developments in funds in recent years

On average, between 2013 and 2015 pension funds have generally become more active in terms of sustainable investment, and this has shown that it is quite possible for a pension fund to develop a more intensive sustainable investment policy. The focus on sustainable investment is only expected to increase.

The most notable developments are as follows:

- The number of pension funds that incorporate sustainability in their investment beliefs has risen quickly in recent years, from just under half of funds in 2013 (45%) to 74% in 2015. This increase shows that opting for sustainability is also based on investment beliefs, and that the focus on sustainability will also apply in the long term.
- The group comprising funds with a more intensive and integrated sustainable investment policy make use of a wide set of sustainability criteria, and between 2013 and 2015 gradually developed policy and made sustainable investments.

- Funds that implemented an active sustainability policy had the most amount showed the most amount of development between 2013 and 2015. By integrating the available sustainability criteria and products such as the best-in-class selection, this group was able to rapidly expand and raise the quality of its sustainable investment policy. It is striking that all the funds in this group without exception have in three years stepped up their efforts in the area of sustainable investment. No funds reduced their efforts. Some funds have since been reclassified as pursuing a more intensive sustainable investment policy.
- Between 2013 and 2015, there were two main developments in the group comprising pension funds with no or limited attention for sustainable investment. Although a shift in policy requires time and resources, and is therefore possibly more difficult for smaller funds to achieve, 40% of these funds were able to develop a more active sustainable investment policy within three years. Among the remaining 60% there was little change in terms of policy and its implementation.

More insight

We based our study on the information about sustainable investment that all pension funds publishes in their reports. This has allowed us to provide an overview of developments in recent years and to give an outline of the sector's current status.

To obtain a greater insight into developments in the area of sustainable investment, it would be desirable for pension funds to share more target information in their accountability documents. We examine this in greater detail in section 3.

Some of the larger funds already share more information, and provide a more in-depth picture of their sustainable investment policy and ambitions in this area. The websites of the two largest pension funds in the Netherlands indicate which part of their assets are sustainably invested.

- ABP wants to raise its investment in the sustainable economy to EUR 58 billion in 2020, compared to EUR 35 billion in 2015. According to figures for mid-2016, sustainable investments currently comprise 10% of the portfolio.
- In addition to this objective, ABP will focus more closely on sustainability aspects in its assessment of 5,000 funds. Pension funds must demonstrate that they are making efforts in the area of sustainability and improving social standards, such as working conditions. Companies which are unable to meet these criteria will be removed from the portfolio. ABP expects that the portfolio will be reduced to 3,500 funds by 2020. The policy also applies to bonds.

- PFZW, the pension fund for the Dutch healthcare industry indicated that it wants to invest EUR 20 billion of its total assets in businesses and projects that have a positive impact on the sustainability. The pension fund also wants to halve carbon emissions produced by its investments by 2020. The fund invests specifically in themes such as climate change, water scarcity, food security and healthcare. Areas such as sustainable energy, clean technology and forestry are high on the agenda. At the end of 2015, these solution-oriented investment amounted to EUR 8.8 billion. In addition to specific impact investments, PFZW would like to fully integrate ESG factors into its investment policy. In mid-2016. PFZW's invested capital amounted to approximately EUR 170 billion.

Standardising ESG information will help to better define and compare these ambitions.

3 Behind the scenes at the funds

How is sustainable investment realised in the pension sector?

The sector comprises a broad range of funds of varying size and nature. The differences between funds are evident in their investment policies and their approach to sustainable investment – which makes it difficult to create a uniform outline of developments in the sector. Nevertheless, we provide an overview of the various developments that are taking place in parallel and indicate where cooperation could lead to further progress with respect to sustainable investment.

In this section we explain how various pension funds have gone about in setting up a sustainable investment policy and how they have put it into practice. We also elaborate on the shift we have observed over the years in pension funds' reasons for engaging in sustainable investment: from a reputation management perspective to a focus on financial risks and, eventually, opportunities. Last but not least, we look at how funds are held to account for their actions and report to their members and other stakeholders.

3.1 Sustainable investment policy: the first steps

An increasing number of pension funds are taking sustainability into account in their investments. It all starts with their investment beliefs. Every pension fund makes its own choices with respect to sustainable investment, but these are not in all cases based on existing sustainability policies.

All in all, it has become easier for pension funds to adopt sustainable investment strategies in recent years, due for example to the increased supply of investment management products and improved availability of ESG information. The increase in sustainable investment can in part be explained from this development. A notable observation is that as demand from the sector increases, more mature products become available.

According to the pension funds, sustainability is an increasingly important criterion in selecting asset managers, boosting this development even further. Pension funds are now looking more closely at the expertise of asset managers and the range of investment products they offer.

But how do pension funds make their choices and how do they design their sustainable investment policies in practice? We have observed the following approaches:

Based on international principles
Some of the smaller and medium-sized pension funds (with managed funds not exceeding EUR 4 billion) have used international principles – such as the UN Global Compact Principles or the Principles for Responsible Investment – as guidance in formulating their own sustainable investment policy and ESG principles. The ESG principles serve as a basis for voting, engagement, choices related

to exclusions and the best-in-class selection. These principles are usually generic in nature, and endorsing them is not necessarily enough to develop a comprehensive sustainable investment policy, as many choices still need to be made.

Based on the asset manager's product range

Some of the smaller and medium-sized pension funds adopt the policy of their asset manager or pension provider, as the volume of their investments is too small to develop an individual sustainable investment policy. Pension providers typically pool participants' assets, and control over sustainability issues is shared between the participants. This complicates a focus on investments that are tailored to an individual pension fund's members, corporate sector or principles and beliefs, as dovetailing investments would entail significant costs. Benefits of scale can help to reduce costs, and cooperation between smaller and medium-sized pension funds with comparable principles may offer an adequate solution. Another option is to select from the range of products offered by the asset manager. In this case, the pension fund must ascertain that the asset manager's choices are in line with its own principles and beliefs. Asset managers and pension providers play a significant role in how and to what extent ESG factors are incorporated into pension funds' investment policies. Pension funds using the same asset manager or pension provider usually share the same sustainable investment policy.

Bottom-up approach

Some pension funds design their sustainable investment strategy from the bottom up. Knowledge gained in practice is first applied to the portfolio as a whole and then laid down in policy. The investment strategy is then fleshed out on the basis of this policy. This approach allows pension funds to develop their vision on sustainable investment more gradually. Many of the larger pension funds already active in sustainable investment presented a comprehensive and updated policy on sustainable investment only in recent years. Pension funds that have embedded their investment policy principles in their investment beliefs indicate that this has helped them in developing and implementing their sustainable investment strategy and in dealing with the sometimes difficult dilemmas this entails.

Own policy tailored to a specific pension fund

Some – mainly larger – pension funds are proactively developing a more far-reaching sustainable investment policy, as has become clear in recent years. They no longer regard sustainability as a separate asset class, but are taking ESG factors into account throughout their investment portfolio. Sustainability is fully embedded into their investment policy, ensuring a comprehensive approach to sustainable investment. Many of these funds also apply a specific ESG policy to each of their investment categories to safeguard adequate implementation of their overall sustainable investment policy. This means sustainability is implemented differently in each of the investment categories: e.g. an exclusion policy for sovereign bonds, a positive selection policy for global shares or a focus on carbon reduction in real estate. Such a broad and holistic approach to the investment portfolio requires significant expertise and may be complex. Adequate resources, including excellent data supply are essential to managing it cost-effectively.

Policy cycle

Some pension funds are actively using an investment policy cycle to control the various sustainability elements in their investment policy. The cycle ensures a consistent approach to sustainable investment, linking policy, implementation, risk management and accountability. Pension funds with a more active approach to sustainable investment too use the policy cycle with the aim of further incorporating sustainability into their investment policy and enhance their impact.

Figure 1 Investment policy cycle

The investment policy cycle: from policy to risk management to accountability

Integration of ESG factors in investment policy? Three important factors

The outcome of a 2005 study by the UNEP Financial Initiative's Asset Management Working Group is often used in considerations regarding sustainable investment. This study focused on the integration of ESG factors into investment policy in different countries, formulating a standard that has remained valid until today. The Working Group identified three situations in which ESG factors could or indeed should be integrated into a pension fund's investment choices.

1. If the integration of ESG information contributes to improved investment analysis, this information must of course be included in the analysis.

2. If institutional investors can choose between various investment products with the same financial characteristics, ESG factors could play a decisive role in their choices.

3. If a pension fund's member base clearly supports sustainable investment this is an important reason for considering ESG factors in balancing investment options, as the involvement of its members is essential to pension funds.

3.2 Implementation: what instruments are used?

Pension funds set up their sustainable investment policies in different ways and to different levels of intensity, and the same is true of their implementation of policy – i.e. the extent to which their investments are truly sustainability-focused. We examined pension funds' sustainable investment methods and the developments in this area.

Exclusions

Sustainable investment policies can be implemented in various ways and at various levels. The most simple method is to exclude certain categories of investments. In addition to investment categories prohibited by law (cluster ammunition producers), pension funds may set their own criteria for excluding specific companies or bonds. Around 90% of all Dutch pension funds have laid down such criteria. Asset managers offer default exclusion options, which means they can be easily implemented into pension funds' portfolios, also in the case of passive management.

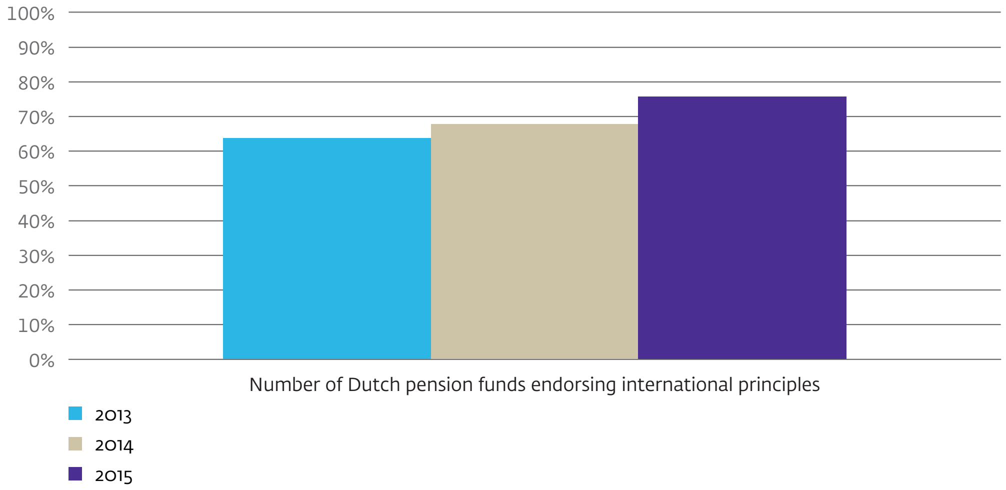
Endorsing international sustainability principles

Three quarters (76%) of all Dutch pension funds now endorse standardised international principles for sustainable investments. Their numbers have increased steadily over the past few years. The ways in which pension funds put these principles into practice differ considerably, however. Some funds regard endorsement of the principles as non-committal, others have taken them as a basis for their sustainable investment policy, and yet others think they should be elaborated further. There are also pension funds that endorse the principles indirectly, through their pension provider. Organisations such as Principles for Responsible Investment (PRI) are developing initiatives to work out the principles in more detail.

A key point for attention is that it is the way in which the asset manager or pension provider implements the principles that makes a difference. It is up to the pension funds to clearly delineate their mandates and monitor implementation.

Chart 2 Principles

In percentages

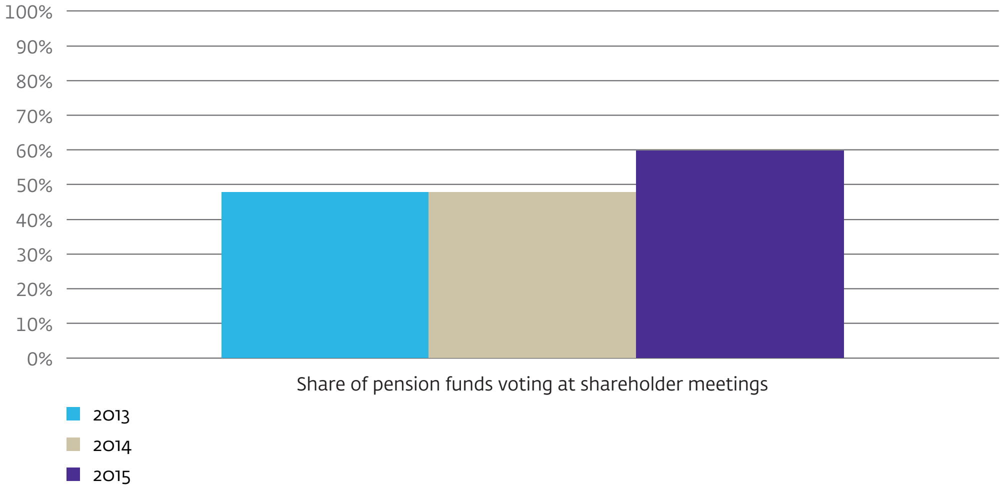


Voting at shareholder meetings

More than half (60%) of all Dutch pension funds use their voting rights at shareholder meetings to promote sustainable investments at the companies they invest in. They do so themselves or engage special – often international – voting agencies to vote for them on the basis of a set of criteria established by the pension fund. To avoid any misunderstandings from arising, pension funds must be very specific in defining their mandate: some international voting agencies may interpret the objectives of Dutch pension funds rather differently. This means that pension funds must closely monitor the execution of their mandates.

Chart 3 Voting

In percentages



Engagement strategy

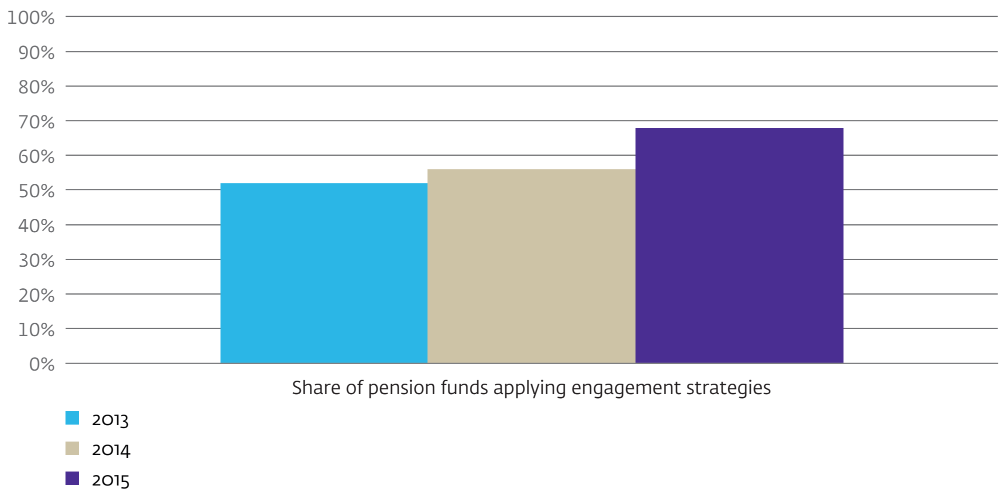
Applying an engagement strategy is an active form of putting sustainable investment strategy into practice. The majority of pension funds (68%) does so, proactively establishing their position as investors. Pension funds urge the companies they invest in to adapt their strategy or governance structure, or to operate more responsibly or sustainably. Engagement strategies vary from a long-term, high-intensity dialogue with a company's senior management, achieving gradual progress, to laborious and difficult issues requiring media involvement in order to get things moving in the right direction. Engagement strategies are often applied by a number of pension funds jointly (national as well as international), and sometimes in tandem with NGOs. Examples include issues such as responsible use of resources or improved conditions of employment for an organisation's staff.

Engagement is an intensive form of active shareholdership, to which pension funds will not commit themselves lightly. Pension funds must have a clear idea of what they wish to achieve, and formulate clear objectives. They must decide in advance on the moments the engagement strategy can be terminated and the position sold should the necessity arise. Exclusion is the last resort in engagement.

As engagement is time-consuming and resource-intensive, many of the smaller pension funds do not apply a full engagement strategy. Smaller funds wishing to apply engagement strategies could well join forces and share the effort, copying the larger funds' strategies. The latter often focus specifically on particular sustainable investment policy issues to keep them manageable.

Chart 4 Engagement

In percentages



Best in class

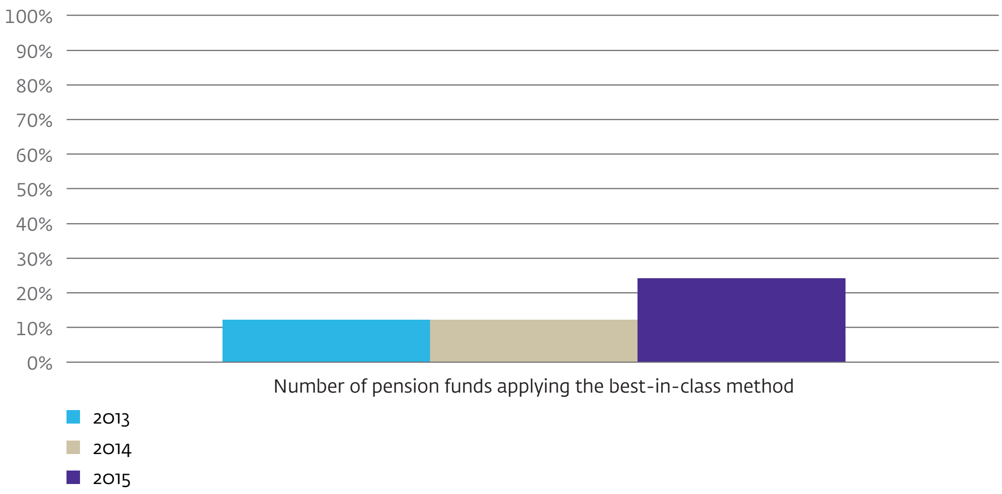
The best-in-class method is a relatively new approach to sustainable investment, which is rapidly gaining in popularity. It means that only those companies are included in the portfolio that score best within their sector on predefined sustainability criteria. The share of pension funds using this method doubled from 12 to 24% in a single year. Initially, it was the company pension funds in particular that opted for this method. The steep increase in popularity resulted from the industry-wide pension funds also adopting it.

In addition, asset managers expanded their range of best-in-class products in recent years, creating simple and cost-effective investment management products that are also available to the smaller pension funds.

It should be noted that a best-in-class investment is not necessarily a specific, sustainable choice but rather the best or least bad option within a particular sector. Funds must proactively indicate their preferences for specific sectors to the asset manager.

Chart 5 Best in class

In percentages



The best-in-class method fits in with the current trend of passive, cost-effective fund management. It entails tracking an index, part of which is then excluded based on standardised ESG criteria. We also observed the development of suitable benchmarks within the sector. Some pension funds have created their own sustainability benchmark. The sector must continue to improve the quality and consistency of ESG information to make further progress, however.

Impact investing

In addition to the methods mentioned above, many of the larger pension funds now shift towards impact investing. It is a form of investing in which funds aim to achieve not only financial but also social yields. It is a solution-oriented investment method mainly used by the larger funds, which is gaining in popularity and will continue to develop.

In impact investing, pension funds focus on themes that suit their members or the sector in which the fund is active. Most of these funds have developed a detailed sustainability strategy over the years, and their size and available knowledge and expertise (also at the pension provider) allow them to invest with impact. The relationship with the pension provider in these new and more intensive forms of sustainable investment focuses more on partnership.

Standardised measuring and reporting of the impact achieved and the risk-return profile is still a challenge. Our analyses of reports show that transparency with respect to the size, results and costs of impact investing is only limited. Some pension funds indicated that they requested impact-related information on investments from their asset manager but failed to receive this, while on the other hand some asset managers said that they were willing to share their impact-related information (such as carbon consumption or employment figures), but that pension funds did not actively request them. In other words, this area of sustainable investment is still under development, and working on coordination and transparency may contribute to progress.

Influence on choices

With respect to the choices made in its sustainable investment policy, a pension fund's size turns out to be a major factor. Larger pension funds tend to have sustainable investment policies that are developed and implemented in far more detail than those of smaller funds. In some cases, for example with company pension funds, sponsors also have a say in the implementation of the investment policy. These funds sometimes feel restrained in setting up a full engagement process with respect to companies from their own market sector, including active voting in shareholder meetings. They also feel that they have to bring the level of sustainability in their investment policy into line with the sponsor's policy.

From policy to practice

Some Dutch pension funds already developed a detailed and far-reaching sustainable investment policy over the past five years. One of these pioneers described how the ambition to integrate sustainability in all investment categories was formulated in 2011. The pension fund started by identifying the themes on which the policy should focus, and the level of integration. Then a plan was drafted setting out the activities to achieve the desired level of integration of sustainability in the portfolio. Some of these activities could be achieved within a relatively short period, such as the implementation of the fund's engagement, voting and exclusion policies. ESG factors were implemented incrementally into the investment policy, developing it further. The most challenging activities included impact investing and improving the measurability of sustainable yields.

Five years later, in 2016, all activities were implemented, and the fund is now clearly regarded as a leader with a fully-fledged sustainability vision and policy.

This illustrates that developing a sustainable investment policy is a step-by-step process that will take some time, which is why pension funds should learn from the larger funds: it all begins with a well-defined policy, which can then be translated into practice.

3.3 Management: from reputation to risk and opportunities

The emphasis that pension funds put on sustainability is evolving. Whereas sustainable investment used to be approached from the angle of the reputation risk posed by investments which society perceived as 'bad', we are now seeing attention evolve from reputation risk to financial risk to financial opportunity.

The emphasis is increasingly being put on the perspective of sustainability as a beneficial and promising investment. Pension funds are also increasingly sensitive to the financial risks associated with non-sustainable investments. An example of the latter is investments in carbon-intensive companies whose value trend may be affected by toughened climate regulations, also known as stranded assets. Environmental, social and governance information is increasingly used in assessments of future portfolio risk exposure.

So corporate social responsibility is being put on the agenda from the perspective of risk management. This provides for more solid embedding of sustainability in investment strategies and makes it into a more fundamental and integrated part of asset management.

Reputation risk

Investments made by pension funds have come under increasingly close scrutiny these past few years. The issue came to the forefront in 2007, following public outrage when pension funds were proved to be investing in cluster ammunition.

To date, reputation management is still a focus of attention. As the pension sector itself puts it: 'where reputation management is concerned, the sector is as strong as its weakest link.' Reputation issues at one fund are very quick to reflect on the entire sector and dent confidence in pension funds.

Reputation risk is playing a particularly important role in the investment decisions of larger pension funds. The public regularly takes large pension funds to task about their investment policies. Their investments are under scrutiny as they concern large sums of money often invested across the globe. The call for transparency about the impact of worldwide investments has also become louder. These funds are more prone to the risk of not complying with their own principles. Smaller funds are not subjected to the same level of scrutiny.

Financial risk

Although important, the reputation angle is no longer the only important incentive for sustainable investment. Pension funds are increasingly acknowledging the financial risks associated with investments in companies with no or weak ESG track records.

ESG risks may manifest themselves directly and indirectly in financial risks. The direct effects can be seen in investments in companies that do not have sufficient attention for ESG factors. For example companies associated with corruption and fraud see their valuations being reduced immediately. Or companies active in sectors with stringent safety and environmental requirements which, due to failing internal risk management do not comply with the prevailing requirements and are consequently exposed to risks that have an immediate negative impact if things go wrong.

Indirect risk impact can be seen at companies exposed to negative external effects that are not sufficiently factored in, such as the effects of climate change. This may influence the investment value of such companies.

Our study has shown that this indirect impact is a relevant theme especially for institutional investors such as pension funds. Owing to their scale and the international spread of their investments, they are more exposed to environmental pollution or climate change, which issues should be addressed. A good example of indirect financial risk is the carbon bubble, which assumes that climate conditions and ambitions will greatly reduce the level of carbon emissions permitted. If this reduction is not sufficiently discounted, financial markets may overestimate the value of fossil fuel reserves and the value of investments may fall.

A recent DNB examination into the impact of energy transition[2] revealed that 5.5% of pension assets is exposed to fossil fuel producers. In the study sample, 5.5% represents a value of EUR 37.8 billion. This means that pension funds are relatively sensitive to the attached downward risk.

The value of ESG results

Asset managers seem increasingly convinced that a financially comparable company that is sensitive to ESG factors will deliver better financial results in the long term. Many recently published research reports show that ESG results precede financial results. This is based on the premise that companies factoring in all environmental factors - i.e. including ESG - create value that society appreciates so much that the company is able to survive in the long term. So attention to sustainability is inherent to a sustainable long-term strategy. This may reduce corporate risk profiles, which pleads the case for including ESG factors in risk management. It may enhance risk perception and enable adequate risk management. Businesses that for instance commit themselves to carbon emission reduction, or improving working conditions will be less sensitive to climate change or claims for damages and they are less likely to suffer unexpected losses in this respect. Pension funds have used engagement trajectories to discuss these topics and they have asked companies to be transparent about their carbon footprint for instance.

ESG information

The increasing availability and quality of ESG information is an important reason behind the equally increasing integration of ESG factors in risk management. Globalisation has increased

2 DNB study 'Time for Transition – an exploratory study of the transition to a carbon-neutral economy' http://www.dnb.nl/en/binaries/TimeforTransition_tcm47-338545.pdf

transparency. Information flows are providing more detailed insight into the ties between ESG risks and investments. The impact of climate change can be expressed better in ESG factors and the effects of climate change on food and water are being translated increasingly sharply into financial investment risks.

Although non-financial information is being considered more and more in risk assessment of individual investments, a full translation of ESG factors into asset valuation is still a bridge too far for pension funds. Some funds already have the ambition to take these steps together with their pension providers and to commit themselves to developing widely accepted standards and ongoing harmonisation.

The urge that asset managers have to gain an information edge over their competitors may act as an incentive for further improving accessibility and effective use of ESG information.

Financial opportunities

Another new aspect of sustainable investment is that it is being viewed as a financial opportunity on the premise that sustainable investments are more profitable than non-sustainable ones. This is still being extensively researched, as the sector wants to increase its understanding of this phenomenon.

It is not easy to assess whether a sustainable investment policy delivers additional returns, or whether it dampens investment returns. This is among other things due to the fact that investment policies differ according to individual fund and often even by asset class, which makes them difficult to compare. Numerous research projects aimed at getting a better grip on this saw the light in the past few years, all based on different data sets and research questions.

The results of studies on sustainable investment returns do not offer any clear conclusions. The pension funds included in our study have confirmed the impression that sustainable investment does not have to come at the expense of return. This for instance applies to the best-in-class selection, which involves exclusion of the sector's worst polluters by means of an ESG filter, enabling funds to continue to invest in all sectors without materially limiting their investment horizons.

Some research reports[3] suggest that if sustainable investment strategies are shaped consistently and responsibly, they may even improve risk/return ratios.

3 Various studies have confirmed that there is a link between ESG factors and financial returns, such as a meta study performed by Deutsche Bank in 2012: https://www.db.com/cr/en/docs/Sustainable_Investing_2012.pdf. In addition, Deutsche Bank and Hamburg University conducted supplementary research in 2015 into 2,000 studies into ESG investing: http://www.tandfonline.com/doi/full/10.1080/20430795.2015.1118917. Improvements in data sets have made studies into ESG investing increasingly similar in set-up.

Social return on investment

In addition to financial opportunities, sustainable investment also offers social opportunities. Large pension funds have clearly voiced that they find it important to also generate social returns on their investments. They aim to use the 'power of money' they invest to create positive impetus in pre-defined areas. The phenomenon of impact investing referred to earlier is a case in point. Determining the social impact of investments is not easy, but it will get increasing attention.

3.4 Transparency: how do funds report?

Now that sustainable investment is being increasingly integrated into investment strategies, having a clear perception of these strategies and their benefits is becoming more and more important. How do funds ensure this? In order to get this into perspective, we reviewed annual reports and available policy documents of pension funds.

Annual reports

Based on Section 135(4) of the Pensions Act, pension funds have since 2014 been obliged to state in their annual reports how their investment policies take account of environmental and climate aspects, human rights and social relations.

Our research shows that 88% of pension funds comply with this new legal requirement and include the details of their sustainable investment efforts in their annual reports. The level of detail in these reports differs, however, meaning that the level of transparency also varies considerably. The 12% of funds that do not report their sustainability efforts have been reminded to do so, and their 2015 annual reports will be assessed accordingly. Auditors and actuaries also have a role to play here.

Code for Pension Funds

The fact that accountability for sustainability is getting increasing attention is not only due to the provisions of the Pensions Act. The sector itself has definitely also taken the initiative, e.g. by means of introducing the Code for Pension Funds that has been in force since late 2013 and was embedded in the law in 2014.

The Code for Pension Funds has self-imposed standards that also include accountability for sustainability. The Code includes a set of 83 standards aimed at effective pension fund management. Three of these standards are aimed specifically at sustainable investment; numbers 27, 28 and 29 state that all pension fund boards must document their considerations with respect to sustainable investment and make them available to their stakeholders. Governing boards should take into account the fund's liabilities and ensure optimum returns at acceptable risk, and create commitment among stakeholders for its sustainable investment decisions.

The code does not prescribe how pension funds should comply with it. The Code for Pension funds is based on the principle of 'comply or explain', and the 2014 report of the Code's monitoring committee does not state which proportion of pension funds complies with which standard. The annual reports of the pension funds themselves do not provide any information either on how the sections of the Code relating to corporate social responsibility are complied with. The monitoring committee does state, however, that a large number of pension funds observe the Code based on 'implicit compliance'.

Policy documents

After studying the annual reports, we also looked at how the pension funds' available policy documents report on sustainable investment. The number of accountability reports on sustainable investment that pension funds produce has substantially increased over the past few years, and their quality is also markedly improving.

The coherence between the content of the annual reports and that of the policy documents, however, is subject to improvement. The accounts given in the annual reports are not always consistent with the underlying policy documents. This may be explained by the fact that although policies have been adequately documented, they have not yet been rolled out completely in practice, due to which they are still getting scant attention in annual reports. It can take more than a year for fundamental changes in investment portfolios to materialise.

Sometimes the content of the annual reports is much more detailed than can be expected based on the image of sustainable investment depicted in the policy documents. In these cases we were unable to assess to what extent these funds actually engage in sustainable investment. Cohesion and consistency in policy and accountability documents can prevent such unclarity.

Better representation of the status of sustainable investment

Although many pension funds are trying to be transparent about their sustainable investment policies, we are still finding it difficult to extract clear information from their reports and policy documents about a number of basic features of their sustainable investments, for instance their size. It would for instance be helpful if pension funds provided information about the proportion of their portfolios that is invested in sustainable investments. This gives stakeholders an understanding of the size and breakdown of these investments across investment classes, and provides the funds with a basis for a stakeholder dialogue.

What may help is differentiating between pre-investment transparency and post-investment transparency, i.e. on investment results, and providing insight into the risk/return profile and the costs incurred. It is also important for pension funds to tune their communications to their target group.

Monitoring

With a view to accountability, the pension sector itself has expressed the need for more available and more granular ESG information. This information may also help pension funds to monitor the impact of their investments more efficiently. Some funds are currently incapable of establishing the actual impact of some impact investments, meaning that they are unable to manage or adjust these investments and to account for them.

Cooperation

The information supply can best be improved by promoting cooperation across the entire chain. Our study has revealed that pension funds as well as asset managers and pension providers are sometimes unaware of the information that the other party has at its disposal, and what kind of information the other party wants to receive exactly. Cooperation between different parties operating in the financial sector may help to facilitate the supply of information, just like further standardising of non-financial information does. There are a large number of international initiatives in the area of standardising ESG information and further efforts in this respect may prove to be an important link in the information supply chain. Disclosing such data may contribute towards enhancing the transparency and consistency of pension fund reports. This may also positively influence the confidence that participants have in their pension funds.

Cooperation and knowledge-sharing is already increasing in the pensions sector: the Federation of Dutch Pension Funds in May 2016 for instance issued a service document on responsible investment in order to provide pension funds with guidance on how they may adapt their processes to responsible investment. Another initiative is the establishment of the Sustainable Pension Investments Lab (SPIL) in January 2016 by the Sustainable Finance Lab. The members of SPIL are experts from within and outside of the pension sector whose objective is to make a contribution to bolstering the sustainability of Dutch pension investments.

Communication with members

During our study, we spoke to pension fund staff about accountability to members and the role and position of members in the development and implementation of sustainable investment policies. There are pension funds that query their members beforehand, but this is not easy as the subject matter is complex and members' answers cannot always be weighed easily.

The sector therefore considers member meetings to be a particularly effective vehicle for accounting for and communicating about sustainability. During meetings across the county, they explain the sustainable investment policies pursued. The funds set great store by the dialogue with their members as it provides them with pointers for further developing their sustainability policies.

Pension fund bodies also play a role in developing (sustainable) investment policies, e.g. accountability bodies or supervisory boards. Pension funds are accountable to these bodies for the investment policies they pursue. Members are also involved in investment policies by means of representative bodies.

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, human rights, and social relations.

This section was added to the Pensions Act in 2013 under the prudent person principle, introducing the reporting requirement in the message from the board as part of the annual report.

The section was added as a result of the increasing public and political attention for sustainable investment. Due to the great importance that pensions have in society, the size of pension assets and the impact that these have in the form of invested capital, explicit attention to sustainability is now also expected in investment policies.

The law does not impose any standards on the degree to which investments must be sustainable investments. Investment policies must be aimed at providing for best-possible pensions against acceptable risks and affordable prices. There are also no legal requirements for the content of the report. It does, however, demand an understanding of the four aspects mentioned.

4 Follow-up actions

Sustainable investment deserves the ongoing attention of the pensions sector and the encircling chain, including DNB. We welcome initiatives to further safeguard developments in the area of sustainability.

Our study resulted in the formulation of five follow-up actions for making a valuable contribution to the further development of sustainable investment from several different perspectives.

Five follow-up actions:

For pension funds (and their managers):

Encourage cooperation within the sector
The sector can gain ground by leveraging the knowledge currently available, sharing the pioneers' views and acting more in concert to promote shared interests.

Focus on making sustainable investment more transparent
Many pension funds would do better to increase the consistency between their annual reports and policy documents, but they should particularly be more specific about their sustainable investment efforts, for instance by specifying the percentage of the portfolio that is invested sustainably and its performance.

Further integrate sustainability further into the investment portfolio's risk management
It is important to take all relevant information into consideration in the investment portfolio's risk management. This also encompasses non-financial information, including sustainability aspects, as part and parcel of adequate risk management. By incorporating all relevant data, pension funds safeguard a well-balanced consideration of interests.

For the entire sustainable investment chain:

Improve the availability, quality and standardisation of ESG information and aim for unambiguous sustainability reports
Our study revealed that, the sector has a need for consistent information on sustainable investment throughout the chain, including between asset managers, pension funds and auditors. Utilisation of technological innovations in the field of data analysis can contribute to this.

Conduct further scientific research and studies into the effects of ESG factors on investment policies
Any consideration underlying sustainable investment must be based on proper substantiation, which requires detailed investigations into a range of aspects. Examples include studying the relationship between businesses' ESG performance and their risk-return profile in the longer term, and back-testing a sustainable investment policy across several years to gain insight into the differences in terms of risk and return relative to a less sustainable investment policy.

Supervisory obstacles?

In our study, we looked at potential obstacles to sustainable investment originating in rules and regulations or supervision. This has as yet not resulted in any specific follow-up steps, but we continue to be receptive to signs from the sector.

Principles for supervision of sustainable investment
Pension funds are responsible for defining what sustainability means to them and how they intend to put it into practice, motivated by their ambitions as well as risk management considerations. They are encouraged to do so by current legislation. The prudent person principle leaves ample scope to design sustainable investment policies, provided that they are compatible with the fund's objectives and in the members' interest and the investment portfolio is sufficiently diversified.

Pension funds basing their operations on sustainability are expected to embed this principle in the elaboration and implementation of their investment policies and to be transparent about their sustainable investment activities. Another key aspect is the match between a pension fund's management and expertise and the nature of its investments, which, naturally, also applies to non-sustainable investments.

Obstacles?
One of the questions we put to the sector was whether our supervision or current legislation creates obstacles to investing more sustainably. Although we received few specific examples, we sometimes observe signs to that effect and the occasional misunderstanding.

Four misconceptions concerning our supervision of sustainable investment

1 **Control**
Pension funds must have adequate control of all their investments, including sustainable ones. If we find that a pension fund lacks proper control, we call it to account. Our intervention is sometimes interpreted as a ban on sustainable investment. We by no means intend to impose any prohibition, but seek to ensure that pension funds adequately manage complex products.

2 **Illiquidity**
Some pension funds believe that a shortage of accessible and marketable investments prevents them from investing sustainably, arguing that they must safeguard the portfolio's security and liquidity and must hold sufficiently liquid investments for collateral and benefit payment purposes. Although all of the above is true, it by no means precludes a sustainable investment policy. Part of the portfolio may be illiquid, as long as its diversification and balance are in order and compatible with the fund's type. Moreover, not all sustainable investments are illiquid by definition.

3 **Costs**
Costs are an aspect playing a particularly important role at smaller pension funds, given that small funds incur relatively higher costs to track a tailor-made sustainable investment index. These factors require pension funds to carefully weigh the investments' added value and the related costs in their decision-making. DNB does not prescribe or regulate investment fees but expects pension funds to be transparent about and able to explain their investment costs.

4 **Required own funds**
Pension funds that deviate from a broad-based benchmark in their equity investments may be exposed to concentration and active management risks, requiring them to hold more capital. Pension funds sometimes have the notion that the exclusion of specific non-sustainable investments constitutes a deviation from the benchmark by definition and hence implies a higher capital requirement. This is not the case. Funds are responsible for selecting the benchmark to track, which may very well be a sustainable one. Provided that the sustainable benchmark is broad based, there is no need for any extra capital add-on. This does require, however, an availability of suitable sustainable benchmarks.

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