



Policy Department

CONFIDENTIAL

DRAFT

15 February 2019

DRAFT OPINION OF THE EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY

of [date Month YYYY]

on the Supervision of the Management of Environmental, Social and Governance Risk by IORPs

1. Legal basis and scope

- 1.1. The European Insurance and Occupational Pensions Authority (EIOPA) provides this Opinion on the basis of Article 29 on Common supervisory culture of Regulation (EU) No 1094/2010¹ (hereafter the 'EIOPA Regulation'). This Article mandates EIOPA to play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union by providing opinions to competent authorities.
- 1.2. EIOPA delivers this Opinion on the basis of Article 25.2(g) and Article 28.2(h) of Directive (EU) 2016/2341² (hereafter the 'IORP II Directive'). Article 25.2(g) specifies that the risk-management system of IORPs shall cover, amongst others and where applicable, in a manner that is proportionate to their size and internal organisation, as well as to the size, nature, scale and complexity of their activities, environmental, social and governance risks relating to the investment portfolio and the management thereof. Article 28.2(h) provides that the own-risk assessment to be carried out and documented by IORPs shall, having regard to the size and internal organisation of the IORP, as well as to the size, nature, scale and complexity of the IORP's activities, include, where environmental, social and governance factors are considered in investment decisions, an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change.
- 1.3. This Opinion concerns the supervision of the management of environmental, social and governance risks relating to the investment portfolio by IORPs.

¹ Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).

² Directive (EU) 2016/2341 of the European Parliament and of the Council of 14 December 2016 on the activities and supervision of institutions for occupational retirement provision (IORPs) (recast).

- 1.4. This Opinion is addressed to the competent authorities (CAs), as defined in point (i) of Article 4(2) of the EIOPA Regulation.
- 1.5. The Board of Supervisors has adopted this Opinion in accordance with Article 2(7) of its Rules of Procedure³.

2. Context and objective

- 2.1. The recast IORP II Directive entered into force on 12 January 2017 and had to be transposed into national law by 13 January 2019. It introduces new requirements at EU level on the consideration of environmental, social and governance (ESG) factors and risks through:
- The system of governance;⁴
 - Investment policy;⁵
 - The risk-management system⁶ and the own-risk assessment⁷;
 - Information to be provided to prospective members.⁸
- 2.2. In addition, Directive (EU) 2017/828, amending the Shareholders Rights Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, introduced new requirements for institutional investors, including IORPs, on public disclosure of their engagement policy on how they integrate shareholder engagement in their investment strategy⁹ and its implementation¹⁰.
- 2.3. EU regulation in the area of sustainable finance is still work in progress. As part of the EU Action Plan on Sustainable Finance, the Commission published on 24 May 2018 three proposals for a Regulation.¹¹ The proposals aim to establish a unified EU classification

³ Decision adopting the Rules of Procedure of EIOPA's Board of Supervisors, available at: https://eiopa.europa.eu/Publications/Administrative/EIOPA-BoS-11-002_EIOPA-BoS-Rules%20of%20Procedure-Rev3.f.pdf.

⁴ Article 21.1 of the IORP II Directive states that "The system of governance shall include consideration of environmental, social and governance factors related to investment assets in investment decisions, and shall be subject to regular internal review."

⁵ Article 19.1(b) of the IORP II Directive provides that "within the prudent person rule, Member States shall allow IORPs to take into account the potential long-term impact of investment decisions on environmental, social, and governance factors".

⁶ Article 25.2(g) of the IORP II Directive states that the risk-management system shall cover "environmental, social and governance risks relating to the investment portfolio and the management thereof."

⁷ Article 28.2(h) of the IORP II Directive states that the own-risk assessment shall include "where environmental, social and governance factors are considered in investment decisions, an assessment of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change."

⁸ Article 41.1(c) and 41.3(c) require IORPs to provide prospective members, both not automatically enrolled and automatically enrolled, with "information on whether and how environmental, climate, social and corporate governance factors are considered in the investment approach".

⁹ According to the new Article 3g.1(a), "the policy shall describe how they monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance, conduct dialogues with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement."

¹⁰ According to the new Article 3g.1(b), the disclosure on the implementation of the engagement policy shall include "a general description of voting behaviour, an explanation of the most significant votes and the use of services of proxy advisors". In addition, institutional investors, including IORPs, "shall publicly disclose how they have cast votes in the general meetings of companies in which they hold shares. Such disclosures may exclude votes that are insignificant due to the subject matter of the vote or the size of the holding in the company."

¹¹ https://ec.europa.eu/info/publications/180524-proposal-sustainable-finance_en

system of sustainable economic activities ('taxonomy'), to improve disclosure requirements on how institutional investors integrate ESG factors in investment decisions and risk processes, and to create a new category of benchmarks which will help investors compare the carbon footprint of their investments. The proposals would also impact IORPs - as financial market participants - by introducing transparency requirements on sustainable investments on their websites, in the Pension Benefit Statement and the information to be given to beneficiaries during the pay-out-phase as well as further detailing the information to be given to prospective members. In addition, the Commission proposal aims to ensure that (1) the prudent person rule with respect to the consideration of ESG risks is taken into account, and (2) ESG factors in internal investment decisions and risk management processes are included.

- 2.4. The objective of this Opinion is to promote a common supervisory culture and consistent supervisory practices with regard to the supervision of IORPs' assessment and management of ESG risks. However, the Opinion recognises that the management of ESG risks cannot be considered in isolation from the consideration of ESG factors in the system of governance, investment policy and information provision to members and beneficiaries. A proper system of governance is essential for sound risk management. A key element of risk management is the mitigation of risks, which in the case of ESG risks can, for example, be achieved by integrating ESG factors in investment decisions and by managing expectations with members and beneficiaries through appropriate communication. Of course, it is recognised that, regardless of any risk exposure, IORPs may consider ESG factors in their investment decision in order to have a positive impact on environmental, social and governance objectives valued by society.
- 2.5. Not only is EU legislation in the area of sustainable finance still under development, including a mapping of sustainable economic activities ('taxonomy'), also the field of ESG risk assessment is still evolving. The incorporation of ESG considerations in investment decisions is relatively new to many NCAs and IORPs, but the assessment of ESG risk is an even less explored area. There is a lack of defined tools and high-quality data for metrics on ESG risks. Therefore, this Opinion contains high-level principles for the supervision of IORPs' assessment and management of ESG risks, encouraging IORPs to take a strategic approach and long-term view and supporting the integration of ESG, and in particular climate change risk, in the IORPs' governance and risk management. Once there is more experience with and knowledge about the assessment and management of ESG risks, the high-level principles may have to be elaborated and further detailed.

3. Taking the above into consideration, EIOPA is of the opinion that

Common understanding of E, S and G

- 3.1. To promote a common supervisory culture with respect to the supervision of IORPs' assessment and management of ESG risks, NCAs should understand environmental (E), social (S) and governance (G) to encompass the following relevant issues put forward by the United Nations-supported Principles for Responsible Investment (UNPRI):

Environmental (E)	Issue relating to the quality and functioning of the natural environment and natural systems. These include: biodiversity loss, greenhouse gas (GHG) emissions, climate change, renewable energy, energy efficiency, air, water or resource depletion or pollution, waste management, stratospheric ozone depletion, change in land use, ocean acidification and changes to the nitrogen and phosphorus cycles.
Social (S)	Issues relating to the rights, well-being and interests of people and communities. These include: human rights, labour standards in the supply chain, child, slave and bonded labour, workplace health and safety, freedom of association and freedom of expression, human capital management and employee relations; diversity; relations with local communities, activities in conflict zones, health and access to medicine, HIV/AIDS, consumer protection; and controversial weapons.

Governance (G)	<p>Issues relating to the governance of companies and other investee entities. In the listed equity context these include: board structure, size, diversity, skills and independence, executive pay, shareholder rights, stakeholder interaction, disclosure of information, business ethics, bribery and corruption, internal controls and risk management, and, in general, issues dealing with the relationship between a company's management, its board, its shareholders and its stakeholders. This category may also include matters of business strategy, encompassing both the implications of business strategy for environmental and social issues, and how the strategy is to be implemented.</p> <p>In the unlisted asset classes governance issues also include matters of fund governance, such as the powers of Advisory Committees, valuation issues, fee structures, etc.</p>
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Manifestation of ESG risks in traditional risks

- 3.2. NCAs should recognise in their supervision that ESG risks tend to manifest themselves as traditional prudential risks, like:
- Market risks;
 - Credit risks;
 - Operational and reputational risks; and
 - Business and strategic risk.
- 3.3. Annex 1 explains how ESG risks – with environmental risks broken down by physical and transition risks and subsequent sub-risks – translate into the traditional prudential risk categories and provides examples of them. The examples should not be interpreted as an exhaustive list but rather as illustrations to support NCAs and IORPs in their thinking about ESG risks.
- 3.4. The provided list of prudential risk categories may also not be comprehensive for all IORPs. For example, ESG risks may not only affect companies included in the investment portfolio but also counterparties of IORPs, including the sponsoring company. Furthermore, climate change may result in more frequent and/or severe natural catastrophes. Insurers usually underwrite catastrophe risk, but it can not be excluded that an IORP's liabilities are also exposed to such risk. For example, an IORP may have a risk exposure towards an increase in mortality rates (due to a catastrophe).¹²

Supervision of IORPs' assessment and management of ESG risks

- 3.5. NCAs should consider IORPs' assessment and management as integral part of their supervision activities.
- 3.6. NCAs should review whether IORPs consider ESG risks in their risk management system and include an assessment of ESG risks in their own-risk assessment, if applicable.

System of governance

- 3.7. IORPs should have in place a system of governance for a sound and prudent management of risks, including ESG risks.
- IORPs should develop, implement and maintain a written policy on the management of ESG risks that is fully integrated in the IORP's overall risk management system, in a manner that is proportionate to the size and internal organisation of IORPs, as well as to the size, nature, scale and complexity of their activities.

The written policy should be subject to prior approval by the management or supervisory body of the IORP and reviewed at least every three years. The review should be aimed at

¹² This would be the case if the IORP does not provide life-long annuities with a risk exposure to lower mortality rates, but does provide cover for survivor benefits with a risk exposure to higher mortality rates.

continuous learning ensuring that the IORP has identified the relevant ESG risks and makes use of the latest best practices in the assessment and management of ESG risks.

The management or supervisory body of the IORP should also approve and review a risk tolerance statement for ESG risks that articulates the nature, types, and levels of ESG risk that the IORP is willing to assume.

The internal audit should provide for independent evaluations of the effectiveness of the written policy on the management of ESG risks and its implementation through the risk management system.

Risk management system

- 3.8. The consideration of ESG risks in the risk-management system means that IORPs should have in place an effective risk management function that facilitates the risk management system ensuring a consistent implementation and maintaining throughout the IORP policies, processes and systems for managing ESG risks in accordance with the IORP's risk tolerance.

The risk-management system should be complemented by an effective internal control system, ensuring that the IORP's policies and procedures as well as laws and regulations, including those relating to ESG, are complied with.

The risk management system should identify, assess, monitor, manage and report to the management or supervisory body regularly the ESG risks to which the IORP is exposed.

The identification of ESG risks should not be confined to market risk, incl. credit risk, but also include other relevant risk categories in which ESG risks manifest themselves, like operational, reputational, business and strategy risk.

Since the assessment of ESG risks is still very much evolving, it will usually not be feasible to measure the ESG risks in terms of monetary impact. This means that IORPs will have to resort to indirect measures of risk, like the (relative) scores of companies on the large number of ESG metrics which are available on the market through (non-financial) performance data providers. One area where considerable advances have been made in quantifying risk exposure relates to scenario analysis with respect to climate change and, in particular, the possible transition paths to a low-carbon economy.¹³ Such scenario analysis allows for a quantitative assessment of some of the new and emerging risks explicitly mentioned in Article 28.2(h) of the IORP II Directive on ORA, like risks related to climate change, use of resources and the environment, [...] and risks related to the depreciation of assets due to regulatory change.

A way to mitigate exposure to ESG risks is to reduce allocations or underweight assets that score poorly on the ESG metrics or to follow a best-in-class investment approach, i.e. by incorporating ESG factors in investment decisions. IORPs should carefully assess and convince themselves that the resulting modifications of the investment portfolio in general enhance its risk-return characteristics. Reducing allocations to certain assets – or even excluding them – may have a negative impact on the diversifying properties of the investment portfolio. In addition, the increasing popularity of ESG investing may drive up prices of companies that perform relatively well on the ESG metrics or even result in, for example, green bubbles. In consequence, the risk mitigation approach may lower the risk-return profile of the asset portfolio instead of improving it. In the end, the prime responsibility of IORPs is to invest the assets in the best long-term interest of members

¹³ Reference to 2degrees and DNB climate change stress test.

¹⁴ The assessment of "social risks" mentioned in Article 28.2(h) would not benefit from advances in scenario analysis relating to climate change and transition risk.

and beneficiaries (prudent person rule) by maximising returns (net of costs) at a given level of risk.

Engagement and the exercise of voting rights will contribute to improving ESG practices of companies and, hence, a reduction in ESG risks. To be effective, this will likely require a concerted effort of institutional investors, including IORPs. Still, acting as responsible, long-term investors through engagement with companies will contain reputational risk.

Transparency can also contribute to mitigating reputational risk. It prevents that members and beneficiaries, other stakeholders and the public will be negatively surprised by the IORP's (responsible) investment policies. Gauging views of members and beneficiaries and reflecting them in responsible investment policies will contribute to aligning the expectations of members and the IORP's approach to ESG. IORPs are required to publicly disclose:

- the statement of investment policy principles (SIPP), including a description on how the investment policy takes ESG factors into account¹⁵;
- the engagement policy, containing a description of how the IORPs engages with investee companies, for example, through the conduct of dialogues with the management of these companies and the exercise of voting rights.

3.9. IORPs should develop contingency plans in case ESG risks materialise. The contingency plans should not only consider an ESG-related materialisation of market risk but also of reputational risk. For example, an IORP should consider its strategy in the event a public controversy arises around one of the companies included in the IORP's investment portfolio.

3.10. NCAs should use a range of supervisory techniques to assess the IORP's management of ESG risks, like reviewing the ESG risk management documents and reports and challenging the IORP on its ESG risk management policy during conversation with its management. NCAs should use the tools most suited to the particular circumstances of the IORP and ensure that deficiencies in the IORP's management of ESG risk are responded to in a proportionate manner.

Outsourcing

3.11. NCAs should ensure that the outsourcing of key functions and other activities does not prevent an effective implementation of the ESG risk management policy.¹⁶ For example, when an asset manager or other external service provider is involved in the management of ESG risks. The NCA should ascertain itself that the IORP has taken the necessary steps to ensure a proper functioning of the outsourcing arrangement of key functions and other activities covered by the IORP II Directive through a proper due diligence, a written agreement clearly defining the rights and obligations and the ongoing monitoring of the service provider.

Cooperation and coordination

3.12. NCAs should encourage IORPs to continually improve their management of ESG risks as the IORPs gain knowledge and experience and the field of ESG risk management develops. NCAs are in a position to compare the improvement efforts with other IORPs to provide the IORP with useful feedback.

¹⁵ See EIOPA, Opinion on establishing principles and guidance with respect to the governance and risk assessment documents to be provided by IORPs to NCAs, EIOPA-BoS-19/xxx, x July 2019.

¹⁶ See EIOPA, Opinion on the supervision of the assessment and management of operational risk by IORPs, EIOPA-BoS-19/xxx, x July 2019.

Proportionality

3.13. As part of exercising proportionate supervision, NCAs should determine the frequency and depth of their supervision of IORPs' management of ESG risks, considering their supervisory priorities and prudential objective of protecting the rights of members and beneficiaries. In doing so, NCAs should take into account the IORPs' characteristics, including their experience with ESG factors and assets the IORP has acquired in the past. EIOPA's Questions and Answers (Q&A) regarding the proportional supervision of IORPs provide further detail.

4. Monitoring by EIOPA

4.1. [To be drafted]

4.2. This Opinion will be published on EIOPA's website.

Done at Frankfurt am Main, XX Month 2019

[signed]

Gabriel Bernardino

Chairperson

For the Board of Supervisors

Annex 1: Mapping ESG risks to prudential risks

ESG risks, in particular climate risk, and society's responses to it, present prudential risks for IORPs. Environmental risks arise through two primary channels. The physical effects of and the impact of changes associated with the transition to a for instance lower-carbon economy. Physical risks are driven by acute events in case of climate risks (such as droughts, floods and storms) or chronic risks may result from the gradual effects of climate change like rising temperature and sea level. Transition risk is driven by developments such as new climate policy, new disruptive technology, shifting investor sentiment or a deteriorated reputation.


In many ways, ESG risks do not necessarily constitute new categories of risk, but translate into existing prudential risk categories, such as credit, market, operational and business model risks for all sectors.

The impact of these risks may vary across IORPs depending on their business model or type of exposures. Physical risks mostly result in large financial losses for insurance firms through their liabilities. However, if losses are uninsured, the burden can also impact asset values of IORPs. As IORPs are mainly exposed through equity, bonds and commodities, they are more vulnerable to market fluctuations.

The geographical distribution of assets can be a good indicator of how vulnerable IORPs are to the physical risks. Mostly for physical risks, the geographical distribution of exposures is relevant as this may indicate how vulnerable a financial institution is to climate trends and events.

The transition channel can be more cross-border driven, as transition risk drivers like technological developments, regulatory changes and market sentiment are also cross border. However, some new climate policies are national and might therefore only affect assets based in a certain country.

The risk mapping below shows how the channels of physical and transition risk may materialise in prudential risks on IORPs' balance sheets.

ESG Risk channel	Sub Type	Market Risks	Credit Risk	Operational & Reputational Risk	Business & Strategic Risk
Environmental Transition risk	Political & legal 	<ul style="list-style-type: none"> - Climate policy can result in write-downs of carbon-intensive investments or sovereign bonds of countries dependent of fossil fuel incomes. - New climate policy can drive certain assets to lose value (e.g. ones below minimum requirements CRE energy label) -Government introduces measures to counter deforestation and land use change, the value of a business's land held for 	<ul style="list-style-type: none"> -Collateral backing of commercial and residential mortgage portfolio decline in value e.g. due to government policy with regards to the energy efficiency of real estate -Prioritisation by government of demand for water, scarcity will put pressure on non-essential business activities and can lead to government decision to close down business (eg Coca Cola had to close three of its 	<ul style="list-style-type: none"> - Operating costs be increased by new environmental policies requiring changes to the investment process or disclosure standards. - Failing to comply with revised environmental regulations lead to compliance breach. - Management and systems do not adapt to, or integrate new environmental policies, 	<ul style="list-style-type: none"> - Fund may be unable to deliver on its pension promise if fails to take into account new environmental policy into business and strategic planning. -Climate related risk for the sponsor impact the continuity of the pension plans operations - Unexpected costs if fails to take into account new environmental policy into business and strategic planning.
	Technology 	<ul style="list-style-type: none"> - Rapidly advancing carbonneutral technology lead to market value losses of carbon-intensive investments or sovereign bonds of countries dependent of fossil fuel incomess "Stranded assets" 	<ul style="list-style-type: none"> -New segmenation and separate "non-ESG" spread; Low ESG scores implies higher credit spreads. 		<ul style="list-style-type: none"> - Risk of failing to take into account rapidly advancing carbon neutral technology into business and strategic planning.
	Market sentiment 	<ul style="list-style-type: none"> - Current underpricing of carbon and climate risk may, due to changing market conditions, result in market value losses of investments in carbon-intensive companies. 			<ul style="list-style-type: none"> -IORP's capacity to write IORP business may be constrained by increasing environmental risks to assets, if risk-based pricing rises beyond demand elasticity and customer willingness to pay. Market contractions are likely to further exacerbate barriers for consumers to
	Reputation 	<ul style="list-style-type: none"> Market value losses of investments in carbon intensive companies due to litigation or shift in consumers preference 		<ul style="list-style-type: none"> - Consumer preferences / public opinion towards carbon-intensive sectors may change, causing potential reputation risks. - Risk of failing to find enough green investment opportunities. 	<ul style="list-style-type: none"> - Fund accumulation (growth) strategy may not be feasible if climate strategy is deemed insufficient.
Environmental Physical risk	Acute 	<ul style="list-style-type: none"> -Loss in market value of businesses in the equity portfolios with facilities located in extremely water-stressed regions are subject to the highest risk of scarcity turning into shortages, which result in a facility's operations being blocked or restricted. 	<ul style="list-style-type: none"> - Pension funds that reinsure (part of) their risks may suffer if the insurer is unable to deliver (e.g. due to insolvency from climate events). -Investments in businesses that depend on critical raw materials face increased market and credit risks as soon as businesses have to deal with raw materials supply issues 	<ul style="list-style-type: none"> Disruption in the distribution of electricity, caused by severe weather, volcanic eruption and flooding, can harm businesses operation. - A big climate event lead to a sudden change of composition a fund's participants. 	<ul style="list-style-type: none"> - Climate event leads to sudden change of composition of fund participants .
	Chronic 	<ul style="list-style-type: none"> - Increase in extreem weather events this lead to higher foreign currency risks for vulnerable countries - Investments in countries that are vulnerable to climate change: investments incur losses following a major disaster if insurers and/or the government do not provide full compensation. 	<ul style="list-style-type: none"> -Some materials used in generating renewable energy have a high long-term supply risk. Mitigating one risk, such as climate-related risk, result in an unintended increase in another risk. For example, if carbon emissions are reduced exclusively by using sustainable technologies, the supply risk of specific scarce raw materials increase. 	<ul style="list-style-type: none"> - Changing weather conditions, temperature and sea level rise lead to lower life expectancy and disability which may lead to risks for technical provisions. 	<ul style="list-style-type: none"> - Uncertainty about the impact of climate change on life expectancy and disability leads to risks for technical provisions.
Social		<ul style="list-style-type: none"> - Association to violations of human rights or labour rights result in reputational damage. The Dakota Access Pipeline in US was financed by a consortium of 17 banks, which various human rights organisations claimed violated the rights of the indigenous population. Wells Fargo lost over USD 3 billion in revenue as customers terminated relationships. -Investments in businesses listed in the MSCI controversies database is an indicator of reputation risk. Increased awareness of institutional investors to exclude controversies result in increased market volatility -Situation of uncertainty results in increased interest rates during times of no collective wage agreements in 	<ul style="list-style-type: none"> -IORP has a concentration in a sector or state with poor working conditions which get struck by public stigmatization or a governmental ban 	<ul style="list-style-type: none"> -Systems/staff not being able to act on previous signals on social risks in their investments and not able to manage ESG risk management -Adverse working/health/safety conditions and low diversity within IORP may lead to lower motivated employees, loss of customers and lower market share. 	<ul style="list-style-type: none"> -poor human capital management results in strategic risks
Governance		<ul style="list-style-type: none"> -IORPS capacity to pay future benefits may be significantly affected if governance factor tied risks significantly disrupt capital markets. -Risk measured as Beta is lower for listed companies with good governance rules in place(research: Jeeon Derwall og Patrick Verwijmeren, 2007) 	<ul style="list-style-type: none"> -Moody's research indicate that excessive bonus payments, which are not in accordance with the size of the companies, increases the probability of default -required transparency in the value chain of a company may result in reputation risks 	<ul style="list-style-type: none"> inadequate governance aroound risk management results in unawareness for ESG risks, which has a significant impact on the viability of sectors, the companies business or it's value chain. 	<ul style="list-style-type: none"> -IORP fails in achieving its strategic objectives from failure to respond to changing governance landscape. -IORP fails in achieving its strategic objectives from losses resulting from an inappropriate strategy relating to governance tied objectives and risks associated with poor management of future plans.