Approaches for a better integration of climate criteria in the investment decisions of the Fonds de Compensation

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1 Introduction

At the World Climate Conference in Paris in 2015, the international community agreed on binding climate targets. The agreed limitation of global warming to well below 2 degrees Celsius requires a comprehensive decarbonisation of the economy. In some sectors, technologies used today will no longer be able to be used in the future. In other sectors, the entire current business model is being called into question.

For investors such as the Fonds de Compensation (FDC), the necessary transformation will have a significant impact on the future financial performance of the companies currently in the investment portfolios. However, the alternative - a "business as usual" approach, accepting climate change - entails far greater financial risks due to physical risks, such as severe droughts and other extreme weather events, but also long-term permanent consequences. At the same time, this approach endangers the livelihoods of countless people and the well-being of the planet. It is therefore not a viable alternative - there is no alternative to economic transformation.

For financial institutions, transformation is highly relevant in two respects. As already described, on the one hand, the business activity and earning capacity of companies and thus their creditworthiness, ability to pay dividends and share price performance are influenced. On the other hand, the financial sector also has an enabler function. In the EU alone, for example, an average of about €180 billion of additional investment per year will be needed by 2030 to meet the requirements of a 2°C compatible transformation path.[1] In global terms, annual investments in the trillions are needed to transform economies.

Policymakers in many countries have already recognised the need for a significant reallocation of capital to avert the most severe impacts of climate change and have since been adapting the legal framework at different speeds in favour of sustainable investment approaches.

For institutional investors, this means that corresponding climate change and transformation risks can only be reduced or opportunities for transformation exploited if a holistic integration of climate criteria in investment decision processes is successful.

2 Opportunities and risks in the climate context

2.1 Impact on financial performance

The <2°C target requires a comprehensive transformation of the economy. Virtually all sectors will be affected by a climate policy geared to the Paris climate targets. However, some sectors are hardly transformable. Studies show, for example, that coal and oil

[1] Dombrovskis (2018)

companies will lose significant value in the coming years when they can only use a small part of their fossil fuel reserves.[2] The extent to which fossil fuel prices respond to changing demand was last seen in March and April 2020, when some countries went into corona-induced shutdown and there was a demand shock on the energy markets. The effects of a <2°C transformation will be less acute. However, they will be permanent, first in the coal sector and then in the oil and gas sector, thus permanently destroying the business model of the specialised pure players. The financial value of these companies therefore moves towards 0 in the long term.[3]

In the short and medium term, the value of individual companies that operate business models incompatible with the <2°C target depends on various factors. These include, among other things, firstly the general economic development, secondly the development of the regulatory framework and thirdly the awareness of the population for climate problems and the associated purchasing behaviour.

In recent weeks and months, various experts have commented on expectations of economic development in times of a global pandemic. V-shaped and U-shaped, but also W-shaped and L-shaped economic developments were discussed as scenarios. Irrespective of the actual development of the real economy, stock prices of almost all major indices at the beginning of July 2020 have, however, already recovered significantly from the lows of March 2020 and made up for a large part of the losses. As stock markets reflect expectations of future economic developments, it is clear that many market participants currently believe in an economic recovery. However, this will largely depend on the success in containing the corona virus and developing drugs and vaccines.

However, the pandemic also shows that the political will to transform the economy at EU level and in many other countries is unbroken. Among other things, a classification system for a better delimitation of ecologically sustainable economic activities has been developed by the EU Commission in recent months and was also adopted by the EU Council in April. A proposal for an EU economic recovery plan to support sustainable industries was also presented and further regulation to improve the transparency of financial institutions with regard to sustainability issues was launched. The EU is therefore taking its Action Plan on Financing Sustainable Growth seriously, increasing the pressure on financial institutions to address the potential regulatory risks for their own investment portfolios. At the same time, the EU taxonomy also increases the risk of being convicted of greenwashing or being exposed as a financial institution hindering the transformation. Reputation effects must also be taken into account by financial institutions.

However, the transformation does not only entail risks. Of course, the restructuring of the economy and the regulations promoting this restructuring also create numerous opportunities. New sustainable product categories are emerging, allowing institutional

2 Carbon Tracker Initiative (2020)

3 On the effects of a 2°C scenario on the long-term financial performance of companies in selected sectors, see Axa (2020)

investors to invest specifically in transformation and benefit from market growth in these areas. Transparency on sustainability aspects is also improving in many sectors, so that far better analysis options are already available today to support sustainable portfolio allocation. At the same time, there is a broad understanding among the population of the need for transformation, so that trustees such as the FDC can assume that their beneficiaries will support them in principle. The fact that numerous studies in recent years have shown that sustainable investments have no systematic disadvantage in terms of return and risk compared with conventional investments is certainly also conducive to this. Many studies even see an advantage for this kind of investment.[4]

2.2 Liability of trustees

For the FDC, in its function as an institutional investor and trustee that manages the assets of its beneficiaries, there is even a special responsibility to integrate sustainability aspects into the investment decision:

Fiduciary responsibility includes incorporating risks and long-term value drivers into investment decisions. A report published by the UN Principles for Responsible Investment (PRI) and the United Nations Environment Programme Finance Initiative (UNEP FI)[5] concluded that it is a breach of the fiduciary duty not to include long-term value drivers such as environmental, social and governance (ESG) issues in investment decisions.

As part of its Action Plan on Financing Sustainable Growth, the European Commission has also defined key points for the exercise of investor responsibility. The EU Commission no longer speaks explicitly of fiduciary responsibility, but of the responsibility of investors in general. As a first step, the measures proposed by the European Commission require institutional investors to provide full transparency on the extent to which their investments are aligned with ESG objectives and criteria.

However, the obligation for more transparency also increases the probability of legal action, because stakeholders will be able to understand much better how trustees deal with potential climate risks. It has already become clear in the past that liability risks for companies promoting climate change cannot be dismissed. In future, it is quite conceivable that lawsuits against asset managers for breach of their fiduciary responsibility will also occur if they do not or insufficiently take into account climate-related risks that affect the return and risk of the capital investments.[6]

4 See e.g. IMF (2019), Friede/Busch/Bassen (2015), S&P (2015)

5 UNEP FI (2019)

6 The case "Mark McVeigh vs Retail Employees Superannuation Pty Ltd" in Australia shows that such risks already exist for trustees, see https://www.equitygenerationlawyers.com/mcveigh-v-rest/

3 Creation of a supportive regulatory framework

In order to accelerate the transformation in line with the Paris climate targets, public organisations with relevant investment volumes such as the FDC must take a pioneering role. They must be obliged by policymakers to set clear targets for investments in climate-neutral and climate-positive economic activities and to withdraw capital from unsustainable investments. It is precisely these investors who, because of the origin of the capital they manage and the purpose of their activities, are particularly committed to the public good. They must therefore act as first movers and pave the way. A number of measures are available to policymakers to achieve this.

3.1 Improving transparency

According to many market players, transparency is the central prerequisite for a systematic understanding and management of climate-related risks. The fact that comprehensive measures have already been taken in many countries to improve the transparency of financial institutions with regard to their climate performance can therefore be regarded as a positive development. In summer 2015, for example, the French legislator was one of the first to adopt an amendment to the French law on energy system transformation. Since then, major investors have been obliged under Section 173 to report annually on the following data:

- the extent to which they have integrated environmental and climate considerations into their investment policies
- the greenhouse gas emissions included in their investment portfolios
- explanations as to how they are contributing to meeting French and international climate change targets
- an assessment of the financial risk arising from climate change that they are exposed to

Pressure on financial institutions to increase transparency is also rising at EU level. While in France one of the aims was to improve the assessment of financial risks, at EU level the focus is clearly on limiting greenwashing. For example, funds labelled as "ecologically sustainable" should disclose the proportion of taxonomy-compliant economic activities in their investment portfolios in the future.

With regard to the FDC, politicians must also formulate clear guidelines to increase transparency: As shown by a Greenpeace analysis published in June 2020, despite its "sustainable and socially responsible investment policy", the FDC continues to invest on an ongoing basis in companies whose business model is not compatible with a <2°C transformation path. In 2019 alone, more than 256 million euros were invested in some of the world's largest coal companies. Several of the sustainably managed sub-funds, including some ESG certified sub-funds, invested in global polluters such as Shell, Total, BP, Chevron, Equinor and Fortum. At first sight, this is in stark contrast to the Paris Climate Targets, which have also been ratified by the Luxembourg government, and to the commitment expressed in the Coalition Agreement 2018-2023 stating that the FDC will be obliged to implement clear sustainable and green investment guidelines.[7]

It is therefore imperative that the FDC creates transparency on how these investments are compatible with existing climate targets. As a framework for disclosure, the Luxembourg government should define the so-called TCFD recommendations[8] as mandatory for the FDC. The Task Force on Climate-related Financial Disclosures is a G20 expert group that in June 2017 published disclosure recommendations for climate reporting to help companies and investors quantify the financial impact of climate change and the associated transformation on their business model. They thus relate directly to the fulfilment of fiduciary duties with regard to the assessment of material financial opportunities and risks in the investment portfolio and are also considered at EU level as an ambitious benchmark for future regulation.

3.2 Mandatory integration into the risk analysis

In line with the extended disclosure requirements, a commitment to integrate sustainability considerations into all funds managed by trustees is also required. With regard to the FDC, the responsible ministries should therefore make it clear once again that financially relevant ESG issues are to be taken into account for all sub-funds - irrespective of whether or not these funds pursue an explicitly sustainable investment approach.

The FDC is currently arguing that an exclusion (e.g. of non-transformable sectors/companies) going beyond the hitherto very "soft" investment directive is not legally possible.[9] A clear signal is therefore also needed from the government to the FDC that this interpretation is not acceptable from a risk management point of view and is contrary to the fiduciary duties of the fund.

At the same time, the government should add sustainability impact issues to the mandates of supervisory authorities. This includes not only the integration of sustainability aspects into reporting and company-specific testing activities, but also the performance of stress tests under various climate change and transition scenarios.

To help financial institutions such as the FDCs to integrate sustainability aspects into risk analysis, we also call on the government and supervisory authorities to create clear

7 See Coalition Agreement 2018-2023, p. 108 and the postulation of the UNEP Roadmap for a Sustainable Financial System (2017), which the government will implement according to the Coalition Agreement.

8 TCFD (2020)

9 See Note on FDC's responsible investor policy (2019)

guidelines for dealing with climate risks in corporations. In the future, this should also limit the complexity of the work of the supervisory authorities and thus allow for a more effective examination.

3.3 Creating know-how and capacities

In order to facilitate the implementation of the previously formulated measures, financial institutions should also receive greater support from the government and related authorities with regard to the substantive work.

For example, the CSSF and the Central Bank should set up a joint working group on capacity building in relation to climate-related scenario analyses and stress testing, thus pooling resources on this topic.

In other countries, it has also been shown that an exchange among financial institutions on key issues in the field of sustainable finance promotes a common understanding and can at the same time create synergies. Such exchanges should be encouraged by the government, for example by establishing dialogue forums.

For the FDC and other trustees, support would also be helpful in developing concrete tools, building up general methodological knowledge and identifying best practice case studies. Here, for example, the CSSF could collaborate with trade associations in order to develop the relevant contents.

4 Approaches for integration

In order to integrate sustainability aspects in general and climate criteria in particular into the decision-making processes of the FDC in a truly holistic manner, various strategic and operational adjustments need to be made. Only the consistent implementation of these measures can ensure that the fund acts in accordance with national and international sustainability goals and that the financial risks associated with climate change or the transformation of the economy are actively integrated into risk management.

4.1 Adapting the investment strategy

The basis for the integration of sustainability criteria is the anchoring of the topic in the overall strategy of the FDC and in the investment strategy for all sub-funds. When formulating strategic sustainability goals and strategic asset allocation, it must be taken into account that the degree to which individual asset classes are susceptible to climate-related risks varies. When selecting investment products within the individual asset classes, however, climate criteria can be taken into account comprehensively in all cases, including investments in equities and bonds, in climate funds and green bonds or in infrastructure and real estate. Even in passively managed funds of the FDC, which invest exclusively in indices, sustainability aspects can be integrated into the investment strategy as a policy objective, since there are sustainable sub-indices[10] for almost all "major" indices.

4.2 Structure of the sustainability analysis

Responsibility for the sustainability analysis of individual investments in the various sub-funds currently lies with the mandated asset managers. Each of the asset managers has its own analysis tools, which are based on different data sources and key figures. A comprehensive overview of the sustainability performance of the capital managed by the FDC is therefore hardly possible. For an effective alignment of capital with national and international sustainability goals, however, it is essential to implement a separate sustainability analysis that creates transparency across all sub-funds on key sustainability criteria.

Rating agencies and other specialised data providers now offer institutional investors appropriate analyses as a basis for climate compatible investment decisions. Its services include carbon footprint and carbon intensity analyses as well as comprehensive sustainability ratings for individual companies. A strict focus on the emission intensity or carbon footprint of the sub-funds is not necessarily required in light of the transformation concept. Even an investment in emission-intensive industries can be considered <2°C compatible if the investees consistently and credibly demonstrate that they have the will and ability to transform and are demonstrably on a <2°C compatible transformation path.

The TCFD recommendations also provide important guidance for the design of the indicator system. The TCFD criticises the fact that the indicators and measures used today for sustainability analysis often focus on developments in the past and therefore do not really go far enough for a future-oriented assessment of climate-related risks. Past performance indicators are therefore quite important for starting a systematic approach to climate-related risks, but should be supplemented by future-oriented indicators.

It should also be noted that many data providers and rating agencies, as well as the mandated asset managers, also provide sustainability KPIs that they have already determined themselves and which bear names such as SDG Score, ESG Score or Climate Excellence Score. These scores consist in part of several dozen individual criteria, which are combined into an overall score using scoring models based on a weighting approach chosen by the data provider. These scores should only be integrated into the FDC's sustainability analysis if the calculation logic is clearly understandable

[10] In this context, attention must be paid to which sustainability criteria are taken into account in the preparation of the sustainability index and whether they fit in with the sustainability objectives of the FDC.

and compatible with the FDC's sustainability goals. The indicator system used by the FDC and the data points used to calculate individual indicators should be made transparent in order to give relevant stakeholders a better insight into the implementation of the sustainable investment strategy.

At the same time, the company's own system of key indicators will make it possible in the future to assess the sustainability performance of the various sub-funds managed by asset managers with regard to their own sustainability objectives and, if necessary, make adjustments in the selection of asset managers.

4.3 Preparation of an investment directive

The FDC already has a Responsible Investment Policy, but only publishes comments rather than the policy itself.[11] It is already clear from the comments that there is no ambitious integration of sustainability criteria across all sub-funds to date.

An ambitious investment guideline breaks down the sustainability goals formulated in the strategy into concrete operational targets. As a rule, it contains provisions on the exclusion of issuers, on the selection of issuers on the basis of positive criteria and on the approach of companies within the framework of dialogue strategies.

The **exclusion** of issuers should prevent further investment in companies with business models that are problematic from a sustainability perspective. The FDC already excludes a few companies from investment due to Global Compact violations,[12] but an ambitious and consistent approach based on national and international sustainability goals is also lacking in this area. From a climate point of view, those companies that have business models that are not transformable per se should be excluded. Also companies that lack the necessary will to transform should be excluded. These include climate change deniers, as well as companies lobbying against measures promoting transformation (e.g. climate-friendly regulation). The FDC must also exclude from investment those companies that are associated with particularly problematic business activities (e.g. Arctic Drilling or the mining of tar sands).

Furthermore, the FDC should specify **positive criteria** on the basis of which it identifies the particularly sustainable companies and systematically gives preference to them in the investment. The approach can be used to identify those who gain an advantage from transformation and the beneficiaries of the FDC can also profit economically from an ongoing trend towards greater sustainability. In this context, the current FDC solution must be seen as suboptimal. Instead of a Positive Impact Fund,[13] positive criteria should

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[11] See Note on FDC's responsible investor policy (2019)

[12] See FDC Exclusion List (2020)

[13] According to FDC, the sub-fund FDC SICAV Actions Monde Sustainable Impact - Actif 1 with a volume of approximately EUR 230 million contains companies that make a positive contribution to the achievement of UN Sustainable

be an integral part of all sustainably managed funds and should be defined as a guideline for asset managers when they are appointed.

The third element is the **dialogue** with companies whose shares/bonds etc. the FDC holds. Instead of divestment, it may well be appropriate to first use one's influence on the company to convince the latter of a more sustainable orientation of its business activities. Depending on the size of the investment, individual discussions, written correspondence or even the Annual General Meeting can be used as a platform. A corresponding engagement concept should be developed and published by the FDC. This applies equally to the commitments made in the respective year and the successes achieved as well as the voting behaviour, which should always be actively exercised by the FDC. In the current constellation, in which the mandated asset managers on occasion enter into commitments without any aggregation on the overall fund basis, the lack of transparency for external stakeholders and probably also for the FDC remains high.

If a dialogue does not lead to the results desired by the FDC, for reasons of credibility, the process will have to end with a regular divestment of the securities of the company concerned. There must be clear guidelines on this from the FDC, which are publicly available and whose implementation can be monitored. Both the level of ambition of corporate reactions to avert divestment and a concrete time frame for the implementation of a divestment should be clearly defined. The explanations of the Sustainable Investing approaches of mandated asset managers do not provide consistently clear statements on this.

4.4 Development of internal processes

Once a corresponding guideline has been formulated and the analysis options have been created, further operational adjustments should be made in order to optimally integrate sustainability aspects into the core business of the fund. This includes, among other things, locating responsibility for the fund's sustainability performance and integrating sustainability criteria into the organisational structure. Sustainability should be understood as a cross-sectional function within the FDC, which has an impact on many areas and departments. A direct reporting obligation of the responsible department to the management/the executive board as well as a representation of the department in all important bodies of the FDC must therefore be ensured.

Consideration should also be given to the creation of an advisory body supported by external experts, including from the NGO community. This can help with gaining both additional know-how and general acceptance for the decisions of the FDC.

Development Goals. It is a niche product for which there is no transparency regarding the investment approach of the Asset Manager (BNP Paribas) on the FDC website.

In addition, investment and controlling processes must be adapted and new services - e.g. carbon ratings - may have to be purchased. The sustainability impact of individual investments and justifications for breaches of investment principles must also be documented by mandated asset managers for the sub-funds and by the FDC in aggregated form across all sub-funds.

4.5 Monitoring and disclosure

Beyond regulatory requirements, there are good reasons to create transparency vis-à-vis beneficiaries and the interested public about the nature, scope and outcome of the consideration of climate criteria. Such reporting not only proves that the FDC fulfils its fiduciary responsibilities, it also has a positive effect on its reputation.

Concrete requirements for the disclosure of key figures result, inter alia, from the TCFD recommendations mentioned above. The following points should also be highlighted:

Disclosure of the:

- investment strategy and relevant investment guidelines, including asset-class specific sustainability approaches
- strategy for exercising voting rights and/or the guidelines of an external voting rights advisor. In addition, a report on the exercise of voting rights should be published annually.
- dialogue strategy in dealing with companies and/or the guidelines of external engagement consultants. An annual report should also be published on the engagement undertaken and engagement successes achieved.
- sustainability performance indicators used to manage the investment funds. This includes not only a naming but also a description of the information content.
- fund units for which sustainable investment approaches are implemented. This should be accompanied by a breakdown of which sustainability criteria are applied to which fund units.
- initiatives, associations and clubs in which the FDC is involved in order to further develop sustainable investment approaches. Examples include PRI, Montreal CarbonPledge, ICGN, and Climate Action 100.

5 Conclusions and recommendations

The FDC is required by law to invest in a broadly diversified portfolio with optimal risk/return considerations to ensure the long-term viability of the pension system. At the same time, the fund is subject to fiduciary duties and must consider the interests of its beneficiaries when investing capital.

There are now numerous studies which show that these two objectives do not contradict each other in terms of sustainability. The consideration of material climate risks has demonstrably had no negative and even tends to have positive effects on the risk/return ratio of investment portfolios and at the same time contributes to the preservation of the environment and thus the habitat of the population. The integration of sustainability aspects into FDC investment decisions is therefore not only a moral responsibility, it also arises as a duty from the mandate of the pension fund.

A review of current practices in FDC's core business shows that sustainability criteria have not yet been consistently integrated into investment decisions. On the one hand, this is due to the clearly too low level of ambition of its own sustainable investment criteria. On the other hand, it must be noted that the approaches of the asset managers mandated by the FDC are also inconsistent and do not correspond by far to the level of ambition that would be necessary to achieve Paris compatibility of the sub-funds.

In addition, the fund has not been able to establish transparency with regard to sustainability aspects in the past. Based on the information provided by the FDC to external stakeholders, it is therefore currently completely unclear how sustainability risks are recorded and managed by the FDC across sub-funds.

In order to remedy these shortcomings and bring the fund into line with the policy objectives, legal requirements and beneficiaries' preferences, immediate action must be taken by policymakers and FDC management:

1. We call on politicians to send a clear signal without delay that the integration of sustainability risks is an essential part of the FDC's mandate.

2. We also call on the FDC to make a clear commitment to achieve the Paris climate targets and to immediately establish transparency on its own sustainability performance. In its disclosure practices, the fund should act as a beacon and pioneer for the Sustainable Finance location Luxembourg by applying the TCFD recommendations.

3. In order to raise the patchwork of the many different sustainability approaches of mandated asset managers to the required level of ambition, the FDC must immediately formulate its own strategy to meet the Paris climate targets, develop

and implement the necessary analytical methods, define much more ambitious targets for mandated asset managers and then regularly monitor compliance with them.

4. The development of additional methodological know-how in the FDC is indispensable for the implementation of this project. The government and associated authorities should facilitate the work of the FDC management through a catalogue of supporting measures, leverage the transfer potential of existing best practices for the fund and at the same time ensure an exchange of knowledge that helps other trustees in Luxembourg to align their investment portfolios with the Paris climate targets.

The time has now come for decisive action on the part of politicians and the financial sector to maintain the image of the Luxembourg financial centre as a pioneer in sustainable finance. A "business as usual" cannot be in the interest of the FDC, the politicians or the beneficiaries of the fund under the rapidly changing conditions.