GISD

Global Investors for Sustainable Development

Alliance

Recommendations to Incentivize Key Actors Along the Investment Chain Towards A Longer Term, Sustainable Perspective

Advance Draft

GISD Task Team 3 Working Group 2

Private Business and Finance

GISD

Global Investors for Sustainable Development

Alliance

Key recommendations

1. Facilitate the alignment of sovereign bonds with sustainable development.
2. Adopt a system-level lens in stewardship approach and move beyond a traditional focus solely on the risk and return of individual holdings to include addressing systemic issues, such as climate change and economic inequality.
3. Take action to significantly enhance alignment of corporate reporting with sustainability and SDG objectives.
4. Ensure commitment to advocacy for policy measures to internalize environmental and social externalities within market instruments, in particular using the full range of policy levers to price carbon.
5. Take action to develop, communicate and operate remuneration policies that include clear links between ESG, where appropriate the SDGs, and remuneration. Furthermore, support the creation of industry specific metrics that impact sustainable development goals which can be used by companies in those industries to set targets and link long term executive compensation to the achievement of those targets.

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Introduction

Achievement of the sustainable development goals (SDGs) as laid out in the 2030 agenda requires significant resources from the public and private sectors. Out of the US$3 trillion required to finance SDGs advancing initiatives in developing countries, there is an annual financing gap of approximately US$2.5 trillion. Both public and private finance are critical for the implementation of the 2030 Agenda. There is significant potential to mobilize additional private investment to close this gap. Institutional investors such as pension funds, insurance companies and sovereign wealth funds hold approximately US$80 trillion in assets. Shifting even 3-5% of this capital towards sustainable development would make a significant contribution for the achievement of the SDGs and transition towards a green economy. For avoidance of doubt, the certain recommendations in this report are not limited to investors referred to above.

The financial markets consist of several different types of investors. The spectra cover short term investors, like for example high frequency traders to long term investors like for example pension fund and insurance companies. The financial markets have for many years evolved into a more short-term oriented market, driven by for example obligations such as quarterly reporting, yearly dividends and performance evaluation of assets and portfolio managers among others. Private investors have for long avoided developing markets due to impediments such as a perception of high risk, low returns, currency volatility and regulatory constraints. These long-standing market dynamics have curtailed impactful long-term investment. Restructuring of the private sector financing ecosystem must therefore be underpinned by policy alignment towards long-termism at all levels. Long-term investment necessary for sustainable development should meet two criteria: first, the investor's time horizon should be sufficiently long to finance long duration assets and, second, the investor should be able to hold a position through economic cycles and downside events.

To procure a shift from short-termism to long-termism within the finance sector, and thereby supporting the achievement of the SDG goals, the incentives within the investment chain should be adjusted. The working group behind this report has reviewed and assessed key actors along the investment chain as presented in the picture below. The review has been done with the aim to identify a handful of recommendations that are actionable and capable of having a meaningful and speedy impact of providing impetus for long termism across the financial sector. We acknowledge that other areas within the finance sector not covered by the recommendations in this report should be further analyzed to identify actions support the shift from a short-term oriented finance sector to a more long-term oriented.

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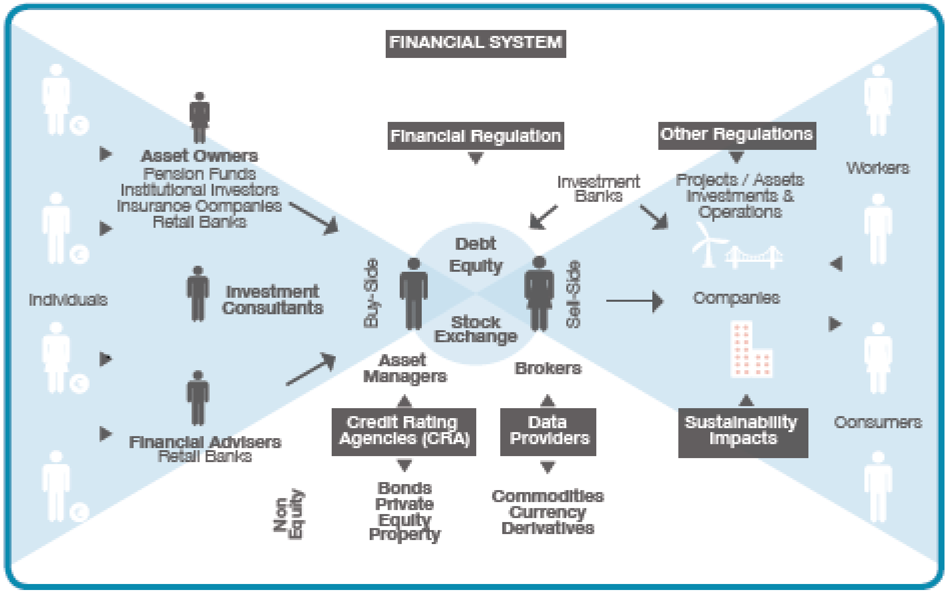

Source: Aviva Investors, European Political Strategy Centre

Based on the above we put forward the following recommendations as a guidance on how the investing could become more long-term oriented and thereby supporting the fulfilment of the SDG goals.

- Alignment of sovereign bond issuance with sustainable investment.
- Stewardship as a tool for aligning with SDGs
- Reporting standards to support assessment and measurement of impact.
- Carbon pricing – internalizing externalities; and
- Remuneration for long-termism.

Recommendations

1. Alignment of sovereign bonds with sustainable development

GISD Alliance should encourage countries and governments that adopt, or have adopted, action plans for achieving the SDG goals by 2030 to measure and report to investors and other stakeholders how public spending supports the adopted action plan for achieving the SDG goals. The Alliance acknowledge the importance of special attention and support for developing countries in this context. The abovementioned reporting can be done as part of relevant annual government budgets or equivalent

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medium-term economic plan(-s). The measuring and reporting is of fundamental importance in order for asset owners and equivalent investors to be able to assess the alignment of their capital allocations through sovereign bonds with the SDGs and to be able to provide transparency and adequate reporting to their beneficiaries. As investors in sovereign bonds, we also encourage governments to leverage the investor's increased demand for investing for SDG aligned sovereign bonds by working with the GISD Alliance members to establish a robust framework for the issuance of (labeled) SGD-aligned sovereign bonds, incorporating best practice in the market. This will further enhance demand and safeguard efficient capital allocation.

Relevance and importance of the recommendation (including how impactful it would be)

In order to achieve the SDGs by 2030 significant private capital needs to be allocated in a meaningful way towards the 17 SDGs. A vast portion of the needed investment capital will have to come from the mainstream capital of institutional investors, such as pension funds and insurance companies, with a natural and relative long-term investment horizon ("Institutional Capital"). Due to applicable regulatory capital requirements and the general product designs of in particular defined benefit and defined contribution schemes with guarantees, the Institutional Capital companies will in a foreseeable future continue to hold in their portfolios a fairly large portion of domestic and international government bonds. From the latest OECD report "Pension at a glance 2019" it is shown that assets in funded and private pension plans and in public pension reserve funds were still invested predominantly in bonds and equities. The proportions of equities and bonds varies across countries but there is, generally, a greater preference for bonds. A large portion of capital is allocated to government bonds (on average ranging between 25-30%). It should be noted that government bonds for the purposes of this paper consist of inter alia government bonds, supra-national government bonds, regional government bonds and municipal government bonds.

As mentioned above, it can be stated that a large portion of the available and meaningful Institutional Capital is, and will continue to be, allocated to government bonds. Hence, it will be of paramount importance to ensure that those assets held by institutional investors can be assessed on their alignment with the SDGs and thereby invested in compliance with the GISD's Sustainable Development Investing (SDI) definition. Investors within the GISD Alliance have the opportunity to encourage

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governments across the world to introduce the abovementioned recommendation, which will incentivize investors to allocate capital towards the achievement of the SDG.

What efforts have been/are being made to implement this recommendation?

To our knowledge, there has so far not been any concerted effort at a global level among investors on taking the actions proposed by this recommendation. The members of the GISD Alliance can actively, jointly and formally reach out to governments asking them to embrace and implement the recommendation. Outreach should preferably be done in the name of GISD and backed up by the members of the GISD Alliance. Outreach should not only be directed towards individual governments, but also include institutions like G7, G20 and EU.

It is a reasonable and logical ask/recommendation given the far-reaching governmental backing of Agenda 2030 (more than 190 countries) and the consensus on the existing funding gap and importance of private capital to bridge the funding gap.

Steps that GISD Alliance would need to take to achieve this

1) Members of the GISD Alliance agree to the suggested recommendation and based on that issue a statement, including an intention to initiate an outreach process with an ambitious timeline for achieving material acceptance and implementation of the recommendation among governments.
2) Set up a structure with adequate resources for the aforementioned outreach with milestones for achieving 50% implementation rate of the recommendation among the governments being signatories to Agenda 2030 by end of 2022 and 100% adherence by end of 2024; and
3) Set up a group assigned to produce in 2022 a framework for issuance of sovereign bonds aligned with the SDGs and SDI definition, building on existing market standards and practices.

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2. Stewardship

Engaged stewardship by investors has the potential of providing impetus for the achievement of the SDG goals.[1] Investors should adopt a system-level lens in their stewardship approach so that, as well as the traditional focus on the risk and return of individual holdings, they conduct "systemic stewardship" or "macro stewardship" – stewardship that relates to the financial system itself and includes engagement with regulators and policymakers to address systemic issues and market failures, such as climate change and economic inequality. Addressing such issues is a prerequisite to long-term returns, healthy economies and the achievement of the SDGs. This will require investors to use a wider range of levers in their stewardship approach, such as engaging with policymakers and greater collaboration with fellow investors.

Co-operation among investors to ensure effective stewardship with the objective of ensuring alignment with Agenda 2030 is an important feature of impactful stewardship. However, the uncertainty and implications of stewardship co-operation being considered as concerted practices under applicable competition law in certain jurisdictions may stifle the effectiveness of stewardship co-operation. Hence, investors should seek clarity where lacking from policymakers on the issue of limits of concerted practices, under applicable competition laws, among investors when jointly co-operating when stewarding the issuers alignment with the Agenda 2030 objectives.

Relevance and importance of the recommendation (including how impactful it would be)

The current prevalent approach to ESG integration and stewardship – focusing only on issues which are currently material to individual companies – will not be sufficient to mitigate systemic risks which will have cascading effects across assets, portfolios and economies. Adoption of a system-level lens will increase the likelihood of, and the contribution of investors to the achievement of the SDGs, each of which represents a current market failure. It will also protect the long-term savings of beneficiaries and more closely align investment practices with their

[1] Berk, Jonathan B. and van Binsbergen, Jules H., The Impact of Impact Investing (August 21, 2021). Stanford University Graduate School of Business Research Paper, Available at SSRN: https://ssrn.com/abstract=3909166 or http://dx.doi.org/10.2139/ssrn.3909166

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preferences.[2] Hence, by adopting a system-level lens the greater focus is towards policy-makers and regulators in order to effectively address market shortcomings related to the achievements of the SDG objectives. Shortcomings that require intervention by policy-makers and/or regulators.

What efforts have been/are being made to implement this recommendation?

System-level investing and stewardship are growing areas of interest within the financial industry and has prompted a spate of recent publications encouraging their adoption.[3] There have been isolated examples of this approach being adopted in policy and practice, though it remains far from the norm.

How achievable is this recommendation? What actions would be necessary?

Given its consequences for overall portfolio returns, an approach to stewardship that incorporates systemic issues is arguably required by the fiduciary duty of investors and as such would be a necessary step-change for the industry.[4] In particular, some jurisdictions require market participants to promote the integrity of markets, which would include seeking the correction of market failures through systemic or macro stewardship.

Many of the necessary changes for this shift need to take place within investors themselves. Stewardship tends to be insufficiently resourced throughout the investment chain; investors need to regard boosting resource allocation to stewardship as both a necessary cost and a high-yield investment given its central role in mitigating systemic risks. KPIs for investment teams should also incorporate targets based on longer-term time horizons and contributions to positive real-world outcomes.

The familiar tools of investor stewardship – corporate engagement and shareholder voting – will remain important and should be used more forcefully. Yet investors should also seek to use the wider range of levers at their disposal to

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[2] PRI, Understanding and aligning with beneficiaries' sustainability preferences

[3] For example, Burckart and Lydenberg, 21st century investing: Redirecting financial strategies to drive systems change; Gordon, Systematic stewardship.

[4] For example, see Freshfields Bruckhaus Deringer LLP, A Legal Framework for Impact: Sustainability impact in investor decision-making, available at: https://www.unpri.org/policy/a-legal-framework-for-impact.

shape positive systemic or macro outcomes, such as engaging with policymakers, collaborating with peers, improving beneficiary voice in investment decision-making and empowering stakeholders impacted by corporate activities.

Steps that GISD Alliance would need to take to achieve this

1) GISD clarifies that a system-level approach to stewardship and investments more broadly is a pre-requisite to achieving outcomes such as the SDGs and the Paris Agreement. This should be a formal position in public policy advocacy and other forms of engagement by GISD.
2) GISD should initiate research into key overlaps between the SDGs and systemic portfolio risks, in particular, understudied social risks, and identify solutions which can achieve portfolio- and economy-wide improvements.
3) GISD Alliance engages with policy making bodies on issues such as the limits of concerted practices and measures to encourage longer-term actions by stewards (*inter alia* stewardship on net zero emissions transition plans, incentive schemes, performance appraisal etc).
4) GISD undertakes outreach with broader universe of investors to create coalition of investors that will push for adoption of a system-wide lens.

3. Reporting Standards

Governments and market participants should continue to support the emerging work of the IFRS Sustainability Standards Board (SSB) to align corporate financial reporting with sustainability by improving global consistency and comparability of corporate sustainability reporting and encouraging the SSB to ensure that as part of its climate first approach it considers interconnected sustainability impact beyond climate and continues to work to cover reporting linked to all SDGs as soon as practicable. In order to move beyond disclosure focused solely on the risks and impacts of sustainability issues to companies and the financial system towards consideration of the risks that companies and the financial system are causing or exacerbating themselves, the SSB's reporting standards must also quickly move to adopt a "double materiality" approach, so as to consider the impact of a company's activities on the environment and society as well as the impact of sustainability issues on the company itself.

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Relevance and importance of the recommendation (including how impactful it would be)

To allow investors to make sustainability-aware capital allocation decisions, there is a need for improved corporate reporting of sustainability information in a globally consistent and comparable manner. The proposed formation of the IFRS SSB, with the support of IOSCO and other global bodies, represents a positive opportunity to create harmonized global standards so long as it quickly moves both beyond climate and to incorporate a double materiality approach.

What efforts have been/are being made to implement this recommendation?

The GISD indicated its support for the IFRS taking this work forward in its July 2020 report "Renewed, Recharged, Reinforced". GISD members should continue to support the work of the IFRS in the run up to COP26 in November and beyond to maximize the chance of success of the SSB and to provide multi-stakeholder investor input to ensure that the SSB's output has the greatest possible benefit and impact.

The IFRS are aiming to create the SSB in the run up to COP26. Investor support and engagement will be needed to ensure its success.

Steps that GISD Alliance would need to take to achieve this

1) GISD members should make a collective public statement in support of the creation of the SSB and commit to engage with the IFRS consultations as the SSB puts sustainability reporting recommendations in place, and will use influence with peers and networks to encourage the same.
2) GISD members collectively and individually engage with IFRS SSB consultations and make calls for input to ensure that a progressive, sustainability-focused investor voice is prominent in the feedback that they receive.
3) Recognizing the reasoning for their chosen climate-first approach, but mindful of the GISD sustainable development mandate, emphasize the interconnected nature of climate and all the SDGs in the initial work of the SSB and encourage them to expand beyond climate to address all of the SDGs as soon as practicable.

4. A Rising Price on Carbon

Governments should commit to policy measures to implement their existing commitment to internalize environmental and social externalities within market instruments, in particular through the use of the full range of policy levers to place a meaningful and rising price on carbon. Having said that, it is important to underline the importance of policy interventions going beyond carbon to other social and environmental externalities.

Relevance and importance of the recommendation (including how impactful it would be)

The market failure to internalize negative social and environmental externalities is one of the biggest obstacles to the allocation of capital in a manner consistent with sustainable development. Market failures require policy intervention to correct them, they cannot be corrected by market participants themselves. Correcting pricing and valuation through the internalization of these externalities so that they are properly reflected in corporate balance sheets is one of the most impactful levers that governments have to encourage investment that is consistent with sustainable development. Internalizing externalities so that the profit motive of companies is aligned to decarbonization would encourage capital to flow to more sustainable assets, thus supporting the funding of the SDGs. In addition to pricing, policymakers should consider adaptation of regulations restricting approvals of new fossil fuels projects[5] and as speedy as possible phasing out any direct or indirect subsidies for fossil fuel extraction and/or use.

What efforts have been/are being made to implement this recommendation?

The UN Secretary General has called for all private sector actors to prioritize reducing carbon emissions and negative biodiversity impacts across their entire value chains and portfolios and to hold the highest standards of environmental integrity. Many GISD members have consistently called for these measures in their policy engagement, as have other market participants and industry bodies. It is essential to the success of this crucial "decade of delivery" that governments are consistently called upon to make meaningful change in this area, and there is

[5] "Net Zero by 2050 – A Roadmap for the Global Energy Sector, IEA Report, May 2021, https://iea.blob.core.windows.net/assets/beceb956-0dcf-4d73-89fe-1310e3046d68/NetZeroby2050-ARoadmapfortheGlobalEnergySector_CORR.pdf

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particular opportunity to do so at this time given the upcoming COP26 Summit and negotiations around article 6.

How achievable is this recommendation? What actions would be necessary?

International commitment to internalizing externalities has had broad support since the Rio Declaration of 1992 but meaningful progress remains to be made. The G7 Finance Ministers' communique of June 2021 provides positive momentum for GISD policy advocacy with its promise: "We commit to properly embed climate change and biodiversity loss considerations into economic and financial decision-making, including addressing the macroeconomic impacts and the optimal use of the range of policy levers to price carbon." But action is needed to back up these words and markets will quickly react to the signals that implementation of a meaningful and rising price on carbon, as required by the science, would send.

1) ***Steps that GISD Alliance would need to take to achieve this*** A public advocacy statement from GISD members seeking:
    i. Support for emission trading systems being implemented by governments in order to safeguard a global level playing field and reciprocity and encouraging the introduction of such systems in countries where they do not currently exist;
    ii. Establishment of an international carbon price floor as put forth in the Common Agenda by the UN Secretary General,[6] and rising the price of carbon for developed countries in line with the G7 leaders' communique;
    iii. alignment of global financial architecture mandates with sustainable development and a smooth and just net zero transition as a necessary corollary to the embedding of sustainability into financial decision making, particularly ahead of COP26 and in relation to article 6.
2) Use GISD policy interventions to support central bank and regulator guidance to implement the NGFS climate scenarios and provide forward carbon pricing guidance to markets.

[6] https://www.un.org/en/un75/common-agenda

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3) Use GISD influence and leadership to support policy interventions from both GISD members and their networks and industry associations that focus on government and regulatory policies that internalize negative externalities consistent with the "polluter pays" principle, starting with an effective price for carbon.

5. Remunerations and Incentives

Companies should develop, communicate and operate remuneration policies that include clear links between ESG, where appropriate the SDGs, and remuneration. These policies should clarify:

i. How remuneration outcomes are linked to ESG issues, including, where relevant any links to appropriate SDGs;

ii. The employee populations who have remuneration linked to ESG, including executives, and other employee groups within the company;

iii. The time horizons over which the assessments will be made;

iv. Within which remuneration elements these will be incorporated, including Short-term Incentives (STI) and Long-term Incentives (LTI);

v. How the remuneration outcomes will be assessed vis a vis the points outlined above; and

vi. Investors also have the ability to influence companies' cost of capital through investments in organizations with demonstrable sustainable practices and strong ESG credentials. Executives of companies should therefore have a material portion of their remuneration delivered in long-term shares and should also be required to have material shareholdings. Companies should develop policies on this which are clearly communicated and effectively implemented. In this way, it is expected that investors have the ability to influence company practices by choosing to invest in companies with strong sustainability and ESG practices and credentials.

Where possible and relevant, these policies should be subject to shareholder votes, through AGM resolutions or similar.

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It is anticipated that the weighting of performance measures in remuneration schemes linked to ESG would increase over time.

Relevance and importance of the recommendation (including how impactful it would be)

Recommendation for companies:

Executive compensation is a key lever used to influence company performance. Structure of executive pay is part of the governance board's focus to ensure company strategy is achieved. Studies have revealed that the way executive remuneration is structured has an effect not only on the financial performance but also on the social and environmental performance of a company. Studies have shown that the greater the short-term focus on executive compensation the less the company has achieved any of the social or environmental goals and conversely the greater the use of long-term focus in executive compensations structuring, the higher the achievement of all goals including the non-financial ones.

What efforts have been/are being made to implement this recommendation?

In the absence of a universal regulatory push to link executive compensation with long term impact on ESG and the SDGs, there has been a lack of a uniform approach to link compensation with non-financial objectives. Different companies have used different approaches and there are studies indicating that the ones that have been able to link executive compensation with long-term goals that go beyond financial metrics have done better than those that have not.

How achievable is this recommendation? What actions would be necessary?

Developing, communicating and operating remuneration policies that are clearly linked to ESG and where appropriate SDGs should be achievable. Many investors and investor bodies in different jurisdictions already require that executive remuneration policies have clear links to ESG and are assessed over a longer period of up to five years. Investors also have a "say on pay", including binding votes on remuneration policies and practices in many jurisdictions. Through these mechanisms, investors have the ability to influence remuneration policies and practices. Investors in many jurisdictions already require executives to have material shareholdings in their companies, including for a period after termination of employment; in this way investors can influence the outcomes for executives

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through their investment choices and choosing to invest in companies with sustainable practices.

What actions will GISD be undertaking to achieve this?

1) The GISD Alliance (i.e. output from Task Team 2) is creating a list of industry specific metrics that impact sustainable development goals which can be used by companies in those industries to set targets and link long term executive compensation to the achievement of those targets. The GISD Alliance should facilitate this process; and
2) GISD Alliance members should collectively make public a commitment to develop, communicate and operate remuneration policies that include clear links between ESG, where appropriate the SDGs, and remuneration.

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Conclusion

Shifting the incentives of key actors along the investment chain towards the long-term is a challenging endeavor, as they require a concerted effort across the investment ecosystem. However, if the current short-term orientation persists, private investment in support of sustainable development will remain below the levels needed to achieve the SDGs. In addition, it may result in private investors forgoing long-term returns, including from long-term investment in in developing and emerging economies. The recommendations put forward in this paper, as summarized below, will incentivize private sector to take a long-term perspective on investment and to achieve greater alignment with sustainable development.

1. Facilitate the alignment of sovereign bonds with sustainable development.
2. Adopt a system-level lens in stewardship approach and move beyond a traditional focus on the risk and return of individual holdings to addressing systemic issues, such as climate change and economic inequality.
3. Take action to significantly enhance alignment of corporate reporting with sustainability and SDG objectives.

4. Ensure commitment to policy measures to internalize environmental and social externalities within market instruments, in particular using the full range of policy levers to price carbon.
5. Take action to develop, communicate and operate remuneration policies that include clear links between ESG, where appropriate the SDGs, and remuneration. Furthermore, support the creation of industry specific metrics that impact sustainable development goals which can be used by companies in those industries to set targets and link long term executive compensation to the achievement of those targets.

Asks for the GISD CEOs:

1) Consider committing to adopting this set of recommendations and incorporate them in their operations.
2) Promulgate these recommendations to other actors in their respective industries and circles in order to increase buy-ins.
3) Under the leadership of the UN, collaborate with governments to facilitate the necessary policy and regulatory changes needed to create an enabling business environment as outlined in these recommendations.

The effectiveness of these recommendations will be deduced from their adoption by the GISD members as well as other private investors outside of the Alliance and their influence on the decision-making processes by the business community and governments.

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