

What can institutional investors do in matters related to climate change and responsible investments?

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[special issue of *Réalités Industrielles*, November 2019]

Abstract:

Institutional investors, everywhere around the world, are involved in the long-term financing of the economy — in France to the tune of approximately €3200 billion (more than a year of GNP), an amount that has constantly grown over the past decades. Dutch retirement funds alone manage the equivalent of more than two years of their country's GNP. The role of these institutional investors depends on whether they are insurance or retirement funds or organizations managing mandatory reserves; but this role is long-term, and this is reflected in portfolio management, which is, paradoxically, subject to various regulatory restrictions. In recent years, financial institutions have turned toward “responsible investments” for sustainable financing the economic activities in which investments are made. This article sheds light on institutional investments, in particular their sustainable dimension (in relation to fields outside finance). In addition, regulatory and bookkeeping trends are explained that tend toward greater economic and social utility.

Who are institutional investors? How do they make investments?

The annual survey by the French Association of Institutional Investors (Af2i) draws a map of institutional investors' activities and portfolios.¹ The 2019 survey (based on data from 2018) covers about 85% of the amount of their investments.² It covers the investments made by the major French players. A French peculiarity: at least half of institutional investors are insurance companies (life and other forms of insurance), which manage nearly two thirds of the total of these investments. In Europe, there is a balance between insurance companies and retirement funds. In a few countries however (Switzerland, the Netherlands and United Kingdom), pension funds are predominant. The retirement segment corresponds to a third of respondents to the Af2i survey and about 15% of total investments. In France, it mainly comprises independent retirement funds, AGIRC-ARRCO, and the provisions made for the civil service retirement system, ERAFP, and the Fonds de Réserve des Pensions. Other long-term provisions are managed by various entities, whether public (*e.g.* Caisse des Dépôts and several other guarantee funds) or private (*e.g.*, firms, especially in nuclear power, not to mention foundations and associations).

¹ This article has been translated from French by Noal Mellott (Omaha Beach, France). The translation into English has, with the editor's approval, completed a few bibliographical references. All websites were consulted in June 2020.

² <https://www.af2i.org/investisseurs-institutionnels/af2i-publication-enquete-af2i-2019-193.html>

The portfolios differ depending on the needs and investment policies of these institutional investors. On the average, the latter invest 72% in bonds and products related to debt, 14% in stock and convertibles, 11% in hedge funds, real estate, infrastructures, unlisted securities and bonds, and the remainder (3%) in liquidities. The category to which an institution belongs influences the choices for its portfolio: in the case of insurance companies, more bonds (about 80%) and fewer shares (below 10%) whereas in the case of the retirement segment, more long-term assets, in particular shares (more than 20%) and hedge funds (more than 15%). Finally, the portfolios of post-value adjustment products (for long-term provisions) are even more exposed to profitable but risky categories of assets, while funds with short-term needs (deposit insurance or foundations like the Red Cross) prefer products that are very liquid and less risky. The size of the institution also influences its portfolio, sometimes paradoxically toward the long term!

Institutional investors' investment policies are gradually turning to asset-liability management. These policies seek to manage financial flows of assets in relation to the needs for liquidity and the amount of liabilities (or equivalent). What Monsieur Jourdain would have done were Molière still among us! The complexity of applying this principle, itself ultimately very simple, is always surprising given that difficulties accumulate when regulatory, prudential and bookkeeping aspects are overlooked (without mentioning the many vehicles proposed by the infinitely creative financial markets). As a consequence, teams of institutional investors try to propose to, and have adopted by, their superiors a distribution of assets that matches as fittingly as possible the institution's finalities and that satisfy a few of the requirements stated hereafter — but, of course, not at any price: variations in stock and bond prices lead to modifying their portfolio strategies and adopting tactics that will be revised annually or quarterly.

Investments are made directly by in-house teams or delegated to assets managers. According to the 2019 survey, more than 70% are, on the average, delegated, even more in institutions that are not big and for classes of assets that require more expertise (mainly foreign or specialized securities, unlisted securities, real estate, infrastructures and certain bond segments). However the management agreements or the products held (mainly in the funds) reflect the needs and wishes of the institutions. So, institutional investors are constantly monitoring their assets and, too, the opportunities and risks that crop up as well as the new services for better positioning their portfolios. Among the noteworthy trends is the strong growth of unlisted securities and direct financing (in particular of firms).

When investors try to take into account nonfinancial criteria, their need for information, analyses and investment services grows considerably.

Extrajudicial dimensions and investor responsibility

Naturally enough, long-term shareholders take under consideration the long-term effects of criteria that might have but little short-term impact in comparison with the noise of the market and the volatility of market prices. Besides, externalities (*i.e.*, side effects as they are called in economics) can be very positive or negative when viewed in relation to an institution's finality. For example, taking account of climate change is, for sure, an important point for insuring damages and even more important for reinsurers, since both the assets and liabilities in a portfolio are going to bear the brunt of natural events, which global warming will make worse and worse. Likewise, an entity active in the health sector (health, casualty, disability insurance) will be concerned with pollution or well-being at the workplace, since these two factors affect public health.

More inclusive approaches to investor financing have been worked out to analyze social and environmental effects, on the one hand, and, on the other, financial returns. These two are sometimes compatible but much more often contraries, labor and capital being the two major factors of production. The investors who pioneered these approaches introduced, often for religious or humanitarian reasons, exclusions in their strategies (*e.g.*, to reject investments in weaponry). A large number of institutions, in particular the more activist among them, have adopted ESG (environmental, social and corporate governance) or SRI (socially responsible investment) strategies. The most radical approach, called "impact investing", seeks to fund only projects or firms with clearly defined positive effects.

These new trends are strong in France, a leader in several of these fields. The portfolio management of more than two thirds of respondents to the Af2i survey took into account extrajudicial factors — twice as many as three years ago. This increase can probably be set down to a provision under the energy transition act in 2016; Article 173 foresees accountability for actions in matters related to the climate and ESG. However this increase also results from public pressure, in particular from the new generations who are very sensitive to the climate emergency or from persons with savings who do not like making investments that might be associated with the scandals or shocking behavior of certain firms (such as Dieselgate).

Conscious of these new issues and of its members' concrete needs, the Af2i is, with the help of the institutions and asset managers that have advanced the farthest in this direction, drafting handbooks on responsible investing. The first one has been devoted to Article 173. Two other handbooks have just been published that present, respectively, basic SRI/ESG indicators and the various experiences of our member institutions with SRI/ESG. A standing committee has been set up to pursue this work in two major directions: one the one hand, designing new solutions and good practices (in particular with NGOs) and, on the other hand, information and education. These actions seek to cooperate on, and share information about, the efforts being made to make adaptations, some of them long-term.

Several questions are worthy of investigation. They will evolve as experiments produce positive or negative results and as research is carried out on techniques or in economics. Among these questions, mention might be made of the many studies on: impact

assessments and their statistical characteristics; the relation between market price trends on portfolio exposure; the strategies of the firms that issue securities; and the balance between financial performance criteria and their extrafinancial impact. Research, regulations and pressure from various sources will make current practices (still disparate) evolve. Internationally, Europeans are leading this trend whereas some American investors still have doubts. Big institutions along with big firms have advanced farthest. Nonetheless, some smaller entities are very activist and are experts on social or environmental questions. A consensus has formed around them in France, a country internationally recognized as being in advance on climate-related issues.

What characterized the first approaches of this sort to investments in energy was the determination to exclude certain sources, such as coal. Investment strategies of this sort were popular in France, which has opted for nuclear power, but unpopular in Germany, which has switched to other forms of (renewable) energy. Realism has led to seeing such investments in relation to the energy transition, which will have a considerable impact on jobs in several branches of the economy. From this perspective, “green” energy represents an interesting investment opportunity. As any experienced investor will admit however, an investment, regardless of the cost, cannot be made without undesirable consequences. Acts of law will not change this state of affairs very much. Several green investment products are now available, such as the green (or climate) bonds issued by firms or states for funding green projects.

International organizations such as the International Capital Market Association (ICMA) are trying to define and steer investments of this sort. This association has inspired other attempts to target investments, such as social impact bonds. The idea is to assess an impact objectively and usefully in relation to an identified goal. Although the offer of impact bonds has grown, especially those related to the environment, it represents a very small part of portfolios, less than 1% for green bonds according to the Af2i survey. Most portfolios are assessed in terms of carbon-related emissions, or eventually emissions of other sorts. The direct and indirect effects are assessed along the whole supply chain and including secondary effects.

Investments in infrastructures might also reflect a preoccupation with, for example, energy issues or social problems. They are a recent development, and the sought-for advantages are of different sorts. The excessive debt carried by nation-states and government debt crises in the eurozone have proven the relative solidity of the issuing authorities, who are normally considered to be “without risk”. Besides, several institutional investors want to make investments for periods much longer than those offered by traditional bonds. So, the demand of institutional investors for securities related to the debt incurred to build infrastructures has grown considerably. Restraints, mainly public or political, subsist but should be slackened given the growing indebtedness of local authorities and states and, too, the considerable need of investments for both ageing infrastructures and the new infrastructures needed for the energy or digital transitions.

How to speed up trends and enable investors to fully play their role?

Political officeholders sometimes seem to have a paradoxical attitude. The regulatory and bookkeeping frameworks for investments are sometimes the exact opposite of the government's economic and social aspirations. In a report to the European Parliament,³ institutional investors, in particular Af2i and several trade associations, made a list of the restraints that hinder them from making efficient investments on behalf of their principals. A timid awareness is emerging about the regulation of insurance firms, the EU's Solvency II directive, International Financial Reporting Standards (IFRS) or the French regulation of retirement funds. But this sometimes much too slow of a start is wasting investors' energy and resources, which could be put to better use on extrafinancial subjects.

A better understanding of these topics by the general public and political representatives would, for sure, accelerate the trend to improve and adapt financial services and regulations. Some investing entities should continue trying to improve communications with their principals, clients or affiliates. One of these efforts is to improve the design of financial products, to orient them more toward themes that people who have savings can understand. Bringing specialists in finance and nonspecialists closer together would give a push to climate-related initiatives. Funding for infrastructures would also increase if the confidence between local authorities, private financiers and contractors were reinforced. After all, the share of private funding is much higher in Canada or Australia.

It is undeniable that cultural biases in France have hampered citizens from improving their understanding of questions related to investments. Unfortunately, financial scandals hit the headlines more often than the trains that arrive on time. It is also undeniable that investors have not spared efforts to adapt their activities and reduce fees and expenses (under pressure, it is true, from competition or regulations). However the more inclusive finance, which (as previously pointed out) Europeans want, will adversely affect some preconceived ideas and reflexes, for example about the difference between competition and cooperation: conventional finance, based on individuals' needs, favors competition whereas the "new" finance, which takes into account extrafinancial criteria having to do with the population or community assets, is based more on cooperation.

³ TASK FORCE ILT DE LA PLACE DE PARIS (2018) "Oser le long terme. Refonder l'investissement pour l'Europe de demain", 66p., available via <http://www.eifr.eu/document/file/download/1963/osser-le-long-terme-pdf>.