

Overcoming barriers to a sustainable financial system: Consultation update

31 July 2013

Summary

Thank you to all the signatories who made submissions to our consultation and the role that the Principles for Responsible Investment (PRI) should play. We received a positive response from signatories overall and the consultation process has been very valuable. It has confirmed that signatories are interested in and supportive of the PRI establishing a sensible, focused programme of work to help address strategic barriers to a sustainable financial system. It has also helped us to identify priority areas of work, generated a series of more specific proposals for work or projects, and alerted us to the issues and concerns of our signatories.

Section 1 provides a summary of the key findings from the consultation and an overview of the consultation process. **Section 2** presents the findings in each proposed research area in more detail and offers an analysis of the organisations that responded. It includes a quantitative analysis of the online survey as well as qualitative discussion of the comments provided through the survey and of the views expressed and issues raised during consultation meetings. **Section 3** outlines the implications of these findings for the PRI. **Section 4** outlines next steps.

1. Summary of consultation

Background

Since its establishment in 2006, the PRI has focused much of its effort on articulating the business case for investors to incorporate environmental, social and governance (ESG) factors into their investment strategies and processes, and on enabling and mobilising asset owners to integrate responsible investment into their relationships with their investment managers. However, the PRI has recognised that more is needed if capital markets are to become truly sustainable and for PRI to achieve its Mission. As a consequence, the PRI's new strategy, agreed by the PRI Advisory Council in March 2012, gives high priority to work to address 'top-down' barriers to the development of a sustainable financial system. These top-down barriers are defined as barriers found in current market practices, structures and regulation that undermine the interests of investors and the systems within which they operate.

The 2013 consultation

In January 2013, the PRI launched a consultation to gain signatories' input to this new area of work. The consultation paper provided an overview of existing research and knowledge on the main obstacles to the development of a sustainable financial system, identifying seven issues – see Box 1 – that are of particular importance. The paper also identified a number of potential project areas and offered some proposals on how the PRI might take this work forward.

Box 1: Key Strategic Barriers to a Sustainable Financial System

- **Company short-termism and overall market returns:**
 - Companies that focus excessively on short-term performance (behaviour which is often encouraged by signals from investors) are likely to disregard ESG factors that could contribute to long-term value creation. This could damage their financial performance and could lead to investment returns being reduced.
 - A lack of attention to ESG-related factors in investment practice could undermine long-term sustainability, potentially further depressing portfolio returns.
- **Investor short-termism, mandate design and alignment of interests:**
 - The design of investment mandates is central to the long-term alignment of interests between asset owners and investment managers, and to the full incorporation of ESG-related drivers of long-term value creation into the investment chain.
 - Short-term behaviour by investors can be exacerbated by pressures from beneficiaries, clients and regulators.
- **Portfolio structure and strategic asset allocation:**
 - Decisions about portfolio structure and strategic asset allocation set the framework for all other investment decisions. The financial crisis showed that conventional approaches to asset allocation and portfolio structure – traditional approaches based on modern portfolio theory and diversification – are not capable of shielding investors from substantial losses triggered by extreme events.
- **Externalities:**
 - There is strong evidence that the economic costs of negative social and environmental externalities are considerable. These may depress the overall performance of the market and likely to be detrimental to long-term investor interests.
- **Financial market stability:**
 - 'Global Systemically Important Financial Institutions' – particularly large investment banks – are important to the stability and functioning of the financial system.
 - The financial crisis highlighted that improving relative performance in a market that has dropped significantly provides little comfort to a long-term asset owner with defined liabilities, or one seeking to maximise retirement income for its beneficiaries.
- **Company disclosure:**
 - The lack of consistent, comprehensive, comparable ESG data from companies remains a major obstacle to progress in making the financial system more sustainable. Full incorporation of value-relevant long-term sustainability factors into the operation of the market will not be possible until and unless appropriate information from companies is available.

- **Financing the sustainable economy:**
 - Global trends such as the de-carbonisation of the economy, the expansion of finance into the ‘bottom billion’ and the need for affordable housing as cities grow will require very substantial allocations of capital from both the public and private sectors.

In addition to the barriers identified above, the paper noted that market frameworks (e.g. the prevailing interpretations of fiduciary duty, pension fund governance) and the behaviours and practices of key investment actors (e.g. investment consultants, investment banks, credit rating agencies, etc.) influence the manner in which these issues are interpreted and acted upon by investors.

The consultation paper sought signatories’ views on the following:

- Whether they agreed that it is appropriate for the PRI to develop a work programme in this area.
- Whether they agreed with the broad analysis set out in the paper and, in particular, the issues that had been identified.
- What projects they considered the PRI might take forward in this area and how.

The process

The PRI launched its consultation in January 2013. Signatories were invited in multiple communications and on the PRI website to provide their feedback via an online survey. In addition, the PRI hosted four workshops (three in Australia and one in London) and two webinars.

Online respondents

The PRI received 66 formal responses to the consultation, with 10 of these provided via email and 56 via the online survey. Appendix 1 lists all of the respondents. Respondents were well distributed across the three categories of PRI signatory, with 27 asset owner respondents, 28 investment manager respondents and 17 service provider and other stakeholder respondents (note that a number of asset owner respondents co-signed a single submission). The majority of responses were received from European organisations but the PRI also received responses from the United States, Canada, Brazil, Australia and New Zealand.

Face-to-face and webinar respondents

The PRI hosted four meetings in Brisbane, Melbourne, Sydney (22-26 March 2013) and London (29 April 2013). In total, 36 organisations participated in the three Australian meetings and 12 in the London meeting. Attendees were evenly distributed between asset owners and asset managers, with a number of service providers also participating. The PRI also hosted two webinars for PRI signatories on 14 February 2013 across different time zones.

2. Key Findings

The key findings from the consultation fall into four broad categories:

- Should the PRI develop a programme of work on the strategic barriers to a sustainable financial system?
- What should the thematic focus of this work programme be?
- What projects might the PRI take forward?
- How might the PRI organise and fund its work in this area?

Should the PRI focus on the strategic barriers to a sustainable financial system?

One of the central conclusions from the consultation is that focusing on the strategic barriers to a sustainable financial system is a relevant and important area for the PRI. This is supported by comments provided in the online survey and by feedback provided during webinar(s) and meetings. Among the comments received were: “[We support] the contention that the PRI should use its position as a global investor group to encourage both change in how markets operate, and how both companies and investors can change their behaviour to enable long term and sustainable returns”, and “We believe that [PRI] is uniquely positioned to spur the research, innovation and collaboration that is needed to move us toward an investment paradigm that relies on long term and sustainable health of the real economy (including the environment) rather than on the relentless pursuit of alpha.”

Respondents raised a number of overarching issues and questions that are relevant to the specific actions to be taken by the PRI in response to the consultation. Specifically:

- A number of respondents questioned whether new work on strategic barriers would divert the PRI’s attention from supporting the implementation of the Principles. The importance of maintaining the PRI’s existing work (e.g. reporting and assessment, implementation support, collaborative engagement) was a key message from many respondents.
- There was a divergence of views on whether the PRI should confine its attention to the actions that investors themselves can take, or whether it should also focus on the role of other actors (e.g. regulators, companies). Some respondents questioned whether the PRI should become a lobbying organisation (e.g. calling for regulation) or continue to focus on making the case for responsible investment and supporting signatories to implement responsible investment. As argued by one respondent: “PRI should be a group of organisations that are convinced due to their own experience and academic studies that responsible investment has clear advantages and generates better risk/return portfolios, especially on the long term.”
- Several respondents stressed the importance of the PRI protecting its own credibility by focusing on areas where it is best able to speak with real expertise and to facilitate signatories collectively to speak with expertise. This issue is discussed further below, in particular in relation to the criteria that the PRI should consider when deciding where to focus its attention.
- A number of the respondents noted that there are already many projects and initiatives addressing barriers to a sustainable financial system (many of which already have active investor involvement), and stressed the importance of the PRI not duplicating work.

Subject areas

PRI's analysis

There was broad support for the PRI's proposition that many of the biggest barriers to making the global financial system more sustainable result from problems at the systemic level and that these problems cannot be resolved by action by individual organisations.

There was also broad support for PRI's analysis of the barriers to a sustainable financial system¹, although a number of respondents (see below) suggested that the PRI should pay greater attention to fiduciary duty, to the implications of existing regulatory frameworks for responsible investment, to pension fund governance, to the specific role played by actors such as credit rating agencies and investment consultants in the operation of the investment system, and to the role that ethical failures played in causing the financial crisis.

A number of respondents, while not challenging PRI's analysis, suggested the PRI's work in this area should flow from bottom-up analysis (i.e. from signatories' experience implementing the Principles) rather than top down approach that was used in the development of the paper. This emphasis is seen, for example, in the projects proposed below.

The hierarchy of priorities

The PRI did not present an ordered list or hierarchy of strategic barriers in the consultation paper. Responses to the online consultation, however, provide a clear indication of what PRI signatories believe are the major barriers. The single most important topic, identified by 92% of respondents as being 'relevant' or 'highly relevant' was investor short-termism, mandate design and alignment of interests; 62% of respondents identified this issue as 'highly relevant'. This view was shared across all categories of respondents, with the exception of asset owners who were equally divided on whether this issue was 'relevant' or 'highly relevant' (although over 90% of asset owners considered this issue in one of these categories).

The other issues identified in the consultation paper (company short-termism, portfolio structure, externalities, financial market stability, company disclosure and financing the sustainable economy) were all agreed to be important, with each being considered 'relevant' or 'highly relevant' by between 65-80% of respondents, although fewer than 50% of respondents identified these as 'highly relevant'. None of the issues identified by the PRI were rejected as 'irrelevant', although a number of respondents did suggest that other issues (in particular, the role of specific market actors and the influence of regulation) were important strategic barriers (see below).

¹ It is important to acknowledge – without undermining this statement – that a number of respondents challenged some of the specific details of the analysis, suggesting that the analysis should be qualified by acknowledging that: (a) not all investment mandates systematically demand short-term performance, (b) speculation is not the only cause of asset mispricing and bubbles, (c) the assumption that green business could be environmental friendly and profitable critically depends on legislation and governmental policy, (d) ESG integration, of itself, will not deliver sustainability and does not provide guarantees that future financial crises may be avoided, (e) some investment consultants have invested significant time and resources in developing their capacity on responsible investment.

The consultation also sought signatories' views on which project/s they would wish to join. While most noted their level of interest would depend on the specific project/s proposed, there was most interest in contributing to projects on investor short-termism (with 74% of respondents that answered this question indicating they would like to be involved) and, to a lesser extent, portfolio structure and strategic asset allocation (53%) and company disclosure (50%).

Short-termism

The majority of respondents agreed that investor short-termism is one of the most, if not the most, significant obstacle to a sustainable financial system. One workshop participant summed up a commonly held view by commenting: "*Short termism is at the heart of all the problems we are talking about here*". Short-termism affects virtually every actor in the investment chain (asset owners, asset managers, beneficiaries, companies, advisers, research organisations, etc.) and the short-term focus of each actor has knock on consequences through the investment chain (e.g. asset owners' emphasis on quarterly performance requires investors to pay attention to quarterly performance which in turn pressures companies to focus on short-term performance).

While this issue is well recognised as a problem, many respondents noted that short-termism is a well-researched phenomenon and there are a variety of projects – most of which have extensive investor involvement – already underway seeking to address this problem. They also pointed out that while the PRI may have a role to play in this area, it is important that it does not duplicate, undermine or interfere with these other initiatives.

Many respondents stressed the importance of any future projects in this area focusing on the *contribution that investors make to the problem and/or the contribution that investors might play in finding solutions*, rather than focusing on company short-termism. A number of respondents noted that company short-termism is frequently a response to the pressures exerted by investors. A focus on the role of investors was seen as aligning with PRI's core objectives and core strength as an investor body. One respondent stated: "*The key barrier is how investors are incentivised to perform in the short run; benchmarks are measured daily and the requirements by our clients is sometimes monthly reporting. As such I think that is the absolute crux of the problem - how do you ensure accountability without losing the benefit of long term investing?*"

Finally, there were a number of divergent views on how the PRI might approach short-termism. One respondent noted that a strengthened focus on the long-term may constrain investors' ability to take advantage of certain opportunities (i.e. investment returns might be harmed). Another warned that attention needed to be paid to the potential consequences of a longer-term focus, commenting that a move to annual reporting may lead to share prices being more rather than less volatile and potentially increase the likelihood of unpleasant surprises. Another noted that the importance of addressing short-termism differs between asset classes, highlighting the management of less liquid assets as an area where investors need to take a longer-term perspective. One meeting participant commented that a short-term focus is simply a reality of modern investment practice, and that the PRI needs to think about how responsible investment might work within this reality.

Externalities

While many respondents acknowledged the importance of externalities – positive and negative – to discussions around a sustainable financial system, most were cautious about the specific role that the PRI or investors could or should play in taking action, with one respondent commenting: *“Externalities are by definition issues that the market does not, or even cannot, take into account. The effort of creating a ‘market’ for every issue that is an externality is monumental (look at the effort necessary just for a carbon market and all its strengths and weaknesses). In a certain sense there will always be externalities that cannot be ‘internalized’. I think valuable resources could be wasted on this issue. Better just to say externalities are important, but maybe government, not the markets, need to take care of them.”*

One of the most significant areas of discussion was whether and how externalities could or should be integrated into investment decision-making. A range of issues were identified, including:

- Whether or not externalities will be internalised (i.e. will regulators actually take action on them). For example, respondents noted that with assets that may become stranded (e.g. oil that cannot be extracted because of concerns about climate change) it is difficult to determine if and when constraints will be placed on them.
- The specific impacts of any internalisation on companies and investors (and portfolios).
- The difficulties in modelling the future, and the reality that such models can too easily be criticised and therefore ignored by investment managers.
- The role of investors in seeking collective or policy solutions to externalities

While these challenges were recognised, a significant number of respondents argued that it is important that investors think about the portfolio implications of pricing externalities, with some describing these as risks that need to be managed or scenarios that need to be considered in investment research and decision-making.

Respondents also noted that a significant amount of work has already been done to assess the implications of pricing externalities on the economy as a whole and on the portfolios of broadly diversified investors, arguing that the PRI should not be seeking to replicate this research.

A number of respondents argued that the PRI should focus its efforts on those aspects of the discussions around externalities that are relevant to PRI’s signatories. Although there was no consensus, suggestions –included:

- PRI build the capacity of institutional investors to work together effectively to engage with policy makers on measures to internalise externalities.
- PRI focus its efforts on infrastructure, in particular the policies (e.g. water pricing, carbon taxes, etc.) required to make “externality-internalising” infrastructure investable.
- PRI link its work on externalities to its work on financing a sustainable economy. The argument presented was that, if ESG externalities become internalised, this may help drive business or consumer efforts to mitigate the problem. However, if externalities aren’t internalised, government action will be required to address the issue. In both cases, this can present investment opportunities as well as risks.
- PRI develop the concept of universal ownership to make it more useful to investors, and to strengthen the justification for long-term value creation across teams within an institution.

Portfolio structure and strategic asset allocation

The PRI received three main comments on this subject.

The first, primarily from US-based research organisations and investors, related to the role that Modern Portfolio Theory plays in portfolio construction, with one respondent stating that investors need “...a new way to evaluate the success of their portfolios in meeting the needs of their beneficiaries by contributing to a flourishing society”. These respondents suggested that there is a need for a new theory (or framework) that considers outcomes such as market beta, the mitigation of externalities, and the level of integration of sustainability issues into investment practice. They also pointed to the need for analysis of the implications of diversification, and whether this has the effect of meaning that no one “owns” the responsibility for reducing risk, leading to risk accumulating within the investment system.

The second set of comments related to whether portfolio structure and asset allocation issues should fall within the work of the PRI’s Implementation Support team, rather than as part of the PRI’s new work on strategic barriers.

The third set of comments related to the clarity of the subject in question, and specifically what the PRI saw as being within the scope of work. Some respondents suggested that the issues around portfolio structure and asset allocation may be better framed as seeking to identify how current approaches to asset allocation limit or undermine allocation to investment opportunities that demonstrate better management of ESG-related risk or the ability to generate ESG-related returns.

Company disclosures

Virtually all respondents agreed that improved disclosure and integrated reporting are critical to enable the integration of ESG considerations into investment decisions. However, most respondents cautioned against the PRI setting up new initiatives in this area, noting that there are many well established reporting initiatives already in place (the majority of which have significant investor input and involvement). It was broadly agreed that the PRI’s primary role should be to promote, encourage and strengthen these existing initiatives. A few respondents noted that the one initiative that the PRI should continue to lead is its work on sustainable stock exchanges.

Financing a sustainable economy

There were mixed views on whether this should be a priority area for the PRI and, if yes, around the specific subjects that it should focus on.

A number of respondents noted a significant amount of work has already been conducted on the design of public policy instruments that facilitate or support a sustainable economy, and that the challenges faced by investors (e.g. lack of policy certainty, limited incentives, etc.) are already well understood by investors. In addition, given that other investment-related organisations are already active in this area, a number of respondents questioned what the PRI’s unique role might be in these debates.

Respondents did, however, identify a number of cross-cutting areas where the PRI might usefully carry out work, including the relationship between thematic/asset class investing and fiduciary duty, the implications of externalities for sustainability-related investments and, more generally, the way that major financial institutions contribute to or undermine sustainability through financing the activities of other companies (including lending).

Respondents also noted that the PRI's relationships and existing networks, including the Global Impact Investing Network (GIIN) and the Global Sustainable Investment Alliance (GSIA), could allow the PRI to act as a conduit for case studies, good practice and analysis of the barriers to mobilising capital to fund ESG solutions. Some also suggested that the PRI may be able to add value by focusing on how investors and policy makers can scale-up these opportunities.

Financial market stability

One respondent suggested that the title of this potential project area be changed to 'Financial market stability and utility', possibly exploring the evolving role and function of financial institutions, and seeking to define what a new, more stable financial market system would look like from the perspective of individual participants in the investment chain.

Another respondent questioned whether the focus on 'too big to fail' institutions was the correct focus for this topic, given different countries have different models for their banking systems which present different types of risks. Connected to this, there was also a comment that the PRI has a role to play working with investors to address behaviours that add to systemic risk in the market.

Other issues

A number of respondents pointed to the need to look at the role played by market actors, in terms of their influence on investors and on the market as a whole. Among those identified were:

- Credit ratings agencies, given the critical role that credit ratings play in many portfolios.
- Asset (investment) consultants, given they are often seen as a key obstacle to investors (asset owners) taking a more proactive approach to ESG issues.
- The sell-side, given that it encourages clients (fund managers) to trade through the provision of research and trading ideas, influences companies through the questions analysts ask and the targets set for expected returns, and influences how companies report their performance. Moreover, given the sell side operates in most markets around the world, it is relevant to PRI signatories in all markets and may make a suitable target for an initiative with global reach.
- Educational institutions (which are already being engaged through the PRI Academic Network).
- Trade associations, in particular their role in public policy.

A number of respondents pointed to the ongoing challenges presented to responsible investment by narrow conceptions of fiduciary duty, in particular in the United States. Respondents argued that the way fiduciary duty is interpreted in the US is used to argue against explicit consideration of ESG-related factors in investment decision-making, and that significant work is required to enable a wider and more holistic interpretation (of the term fiduciary duty itself as well as related terms such as duty of loyalty) to gain widespread adoption.

Finally, some respondents noted that issues within individual markets have a profound impact on market stability and on the manner in which investors implement their approaches to responsible investment. Among the examples cited – not proposed as project areas but rather as illustrations of the issue at hand – were the consumer orientation of the pensions system in Australia, liquidity rules that affect the types of investments that investors can make (which may militate against longer-term investments), and the role played by distribution networks in Italy in promoting socially responsible investment. Respondents did note that in many cases, these regulatory issues reflect both the manner in which the particular market has developed over time and, in relation to regulation/policy, the fact that policy makers are frequently faced with choices between competing agendas (e.g. in the Australian example, the trade-offs between consumer choice and freedom and impacts that may have within the market).

Projects

While there was a general consensus around the priority subject areas, relatively few respondents identified or proposed specific projects that the PRI could or should take forward; most respondents pointed to potential areas for further research and investigation rather than offering fully defined project proposals. The PRI has collated the suggestions it received below, mapping them (as far as possible) against the broad areas identified in Box 1.

The PRI is not offering a view on the merits of each proposal although many of the proposals overlap with or potentially duplicate areas where a significant amount of work is already underway (either within the PRI or elsewhere). Views on the PRI's role in these potential projects differ, with some pointing to areas where the PRI could lead and others to areas where it might catalyse work or act as a facilitator or distributor of information and research. The PRI's role is discussed in more detail below.

Investor short-termism

- Analyse how investor behaviour (in particular short-termism) impacts on company behaviour and practices.
- Design investment mandates that encourage investment managers to take a longer term view on the value of a company due to ESG factors. The project could include: (a) analysis of which investment strategies – hedge funds, passive, active; private markets – are best at factoring in long-term ESG information; or (b) the development of guidance on ESG policy and mandate design.
- Evaluate the implications for investor/company relationships of investors holding more concentrated portfolios of companies.
- Identify and assess (from an investment and a commercial perspective) where asset owners and asset managers have tried to make progress (e.g. moving to 3-year rolling incentives, encouraging companies to move away from quarterly reporting, moving away from assessing performance against benchmarks) on short-termism.
- Develop a robust evidence base to demonstrate when and how short-termism presents challenges to ESG integration and potentially undermines returns.
- Analyse the psychological factors that drive short-termism.
- Consider whether the theory of 'universal ownership' can be used to develop the justification

for long-term value creation within organisations and across the market as a whole.

- Analyse the role that credit ratings agencies play, or might play, in encouraging investors to take a longer-term view.

Portfolio structure and strategic asset allocation

- Develop tools that enable the 'social purpose' or sustainability characteristics of asset classes to be assessed and integrated into asset allocation decisions.
- Assess how current portfolio and strategic asset allocation approaches affect investors' willingness or ability to invest in companies that are better at managing ESG-related risk or generating ESG-related returns.
- Provide guidance on how the effects of externalities and exhaustible resources might affect macroeconomic forecasts (e.g. GDP projections).

Externalities

- Develop a blueprint for how investors might navigate the issue of externalities over 20-30 years, setting out: (a) what it is that investors can realistically do and over what timeframes, and (b) what it is that governments and other actors could or should do to enable these issues to be addressed.
- Analyse the economic implications of the investment industry failing to address issues such as resource scarcity and pollution in its financing and investment decisions.
- Develop tools that enable externalities to be measured and reported by investors, and encourage reporting on externalities alongside conventional investment metrics.

Financial market stability

- Analyse the implications of (implicit/explicit) public sector guarantees for the banking sector for the stability of financial markets as a whole.
- Examine the theoretical/conceptual foundations (e.g. shareholder primacy, Modern Portfolio Theory, Efficient Markets Hypothesis, prevalent definitions of fiduciary duty) that underpin modern investment practice and analyse how these promote the exclusion of ESG factors, encourage short-termism and stand in the way of the achievement of sustainable financial markets.
- Develop tools to enable the interactions between specific risks to be assessed (e.g. under what conditions might economic, social or environmental risks interact to create the risk of conflict?).
- Research the impact of certain investment products (e.g. derivatives, hedge funds) or practices (e.g. high frequency trading) on financial market stability.
- Define what a sustainable financial system looks like. This may require that investors move beyond the term ESG and look at concepts such as resilience, integrity and stability.
- Define the (social) purpose of the financial system and determine what investors can do to encourage leaders in the financial services industry to fulfil their purpose and contribute to stability.
- Assess the role that ethical failures played in causing the financial crisis and the role that ethics plays in a sustainable financial system.
- Analyse the implications of 'too big to fail' organisations on the stability of the investment

industry, including consideration of the implications of an economy being made up of many small institutions (e.g. the trade-offs between scale and efficiency).

- Analyse whether there is a balance between investing in the 'real economy' (real assets) versus the 'financial economy' (financial assets) in a sustainable financial system.
- Analyse the human and economic consequences of business practices such as offshoring.
- Assess whether tax systems could be adjusted to encourage the direction of capital towards productive areas of the economy.
- Assess whether a sustainable financial system that rewards investment and delivers long term economic growth is possible if trends in income inequality are not reversed.
- Explore alternatives to current Value- at- Risk (VaR) models.
- Analyse the tensions between financial markets and climate change policy objectives and, based on this analysis, define what a prudent level of coal, oil and gas assets in an investors' portfolio should be.
- Assess the impact of the 2007 European MiFID Directive on the development of dark pools (i.e. pools of liquidity that can be accessed electronically and where there is no pre-trade transparency regarding the orders that are received by the pool) and high frequency trading.
- Assess the impacts of alternative asset classes on the stability and sustainability of the financial system.
- Analyse the economic and economy-wide impacts of money supply and banking. This could consider the role of the current monetary system, the role of the banking sector in contributing to economic instability, and potential actions or reforms that could benefit pension funds, asset owners and their beneficiaries.

Financing the sustainable economy

- Identify the characteristics of public policy frameworks and instruments (e.g. carbon taxes, water pricing) necessary to encourage investment in sustainable ('green') infrastructure.
- Identify and analyse unintended regulatory barriers to financing sustainable ('green') infrastructure (e.g. Solvency 2 in Europe).
- Assess the impact of accounting rules and legitimate prudential regulation on investment time-horizons and volatility.
- Review the utility (i.e. positive and negative economic, social and environmental impacts) of the financial services industry.
- Review how the role, function and utility of various financial institutions have changed over time.
- Analyse how major financial institutions contribute to or undermine sustainability through financing the activities of other companies.
- Define the role of the banking and monetary system in a sustainable financial and economic system.

Investment practice (responsible investment and ESG integration)

- Develop tools that enable investors to differentiate between companies with short-term and long-term structures, incentives and approaches to value creation.
- Develop tools that enable investors to build consideration of ESG-related issues into their investment analysis and decision-making processes.

- Develop tools that enable investors to take account of 'natural capital' in their investment decisions.
- Examine the relationship (both areas of alignment and of conflict) between respect for ESG-related norms (e.g. on human rights) and fiduciary duty. For example, a project on human rights could examine whether it is feasible to move beyond a focus on human rights as an investment down-side risk, towards positive investment valuations for companies that excel in human rights performance.
- Review how resource companies are valued, focusing on issues such as the valuation of oil and gas companies in a carbon-constrained future (this may include analysis of metrics such as reserves replacement ratios, which reward finding more fossil fuel reserves without considering the impact of emissions constraints on the markets for the products) and the potential for higher valuations as a result of excellence in managing ESG issues.
- Support the development of macro- and microeconomic indicators that enable the full social and environmental impacts of investments to be assessed.
- Develop metrics that allow investors to communicate how their activities have contributed to social and environmental outcomes (e.g. the number of jobs a particular portfolio helped create).
- Develop tools that enable asset owners to determine how their actions as investors help and harm other parts of their portfolios, as well as help or harm their own beneficiaries in their real lives.
- Assess whether/how ESG-related factors might be built into portfolio stress testing.
- Assess how serious asset owners are about ensuring that their asset managers take a responsible approach (e.g. how robustly do asset owners ensure that the principles set out in investment mandates are actually implemented?).
- Develop scenarios that can be used by investors to engage with companies on sustainability issues.
- Analyse the investment chain as a whole, and analyse the consequences and impacts of the incentives faced by different actors in the investment chain. This could include incentives to externalise certain types of harm caused by investment practice.

Fiduciary duty

- Analyse/define the role and responsibilities of fiduciaries and trustees.
- Clarify the interpretation of company directors' duties, in particular those that preclude their attending to problems that their companies may be creating for other companies, the market or the economy.
- Develop a pool of knowledge and resources for fiduciaries that enables them to effectively participate in discussions with governments and other actors on the long-term needs and interests of beneficiaries.
- Explore the potential for fiduciaries to collaborate and work together (e.g. through sharing research resources, pooling funds to reduce fees, challenging investment managers on mandates and fee structures).

The market for responsible investment

- Make the case for responsible investment, explaining why ESG issues are important, providing evidence of the potential for improved investment performance through a focus on ESG issues and explaining why investors should be concerned about wider market issues such as short-termism, externalities, and the sustainability of the financial system.
- Research the evolution of responsible investment in different markets/geographic regions to identify the key success factors and the factors that influence the specific shape and form taken by responsible investment in different markets.
- Analyse the impacts of monetary policies on long-term financial system effectiveness, stability, and sustainability.
- Assess how the design and regulation of pension systems impact on the development of sustainable capital markets, and the ability of investors to think about long term factors.
- Determine whether there are shareholder democracy issues that limit the ability of investors to effectively engage with companies (e.g. flaws in the global proxy voting system, proxy access or acting in concert rules, and majority voting policies).
- Critically assess the implementation of existing legislation directed at promoting more responsible investment practice.
- Assess the implications for responsible investment of the trend worldwide to move away from defined benefit (DB) pension schemes towards defined contribution (DC) systems, and how long-term considerations can be built into the investment structures of DC schemes, and in the regulatory structures that govern them.
- Assess the implications for responsible investment resulting from the growth in fiduciary management and liability-driven investing.
- Analyse how different factors might be traded off within the design of pension schemes (e.g. customer choice versus longer-term investment horizons). Identify whether there are particular pension system designs that are more conducive to long-term sustainable investment.
- Develop a framework for meaningfully evaluating and comparing the investment practices and processes of PRI signatories.
- Work with small asset owners to encourage them to take a more proactive approach to responsible investment.
- Analyse how pension fund governance affects the decisions made by trustees.
- Analyse the barriers to implementation. For example, while a growing number of asset owners incorporate ESG factors into requests for proposals (RFPs), relatively few seem to monitor how investment managers integrate ESG factors into their investment decisions.

Agency (or principal-agent) issues

- Analyse the myriad conflicts that exist within the current investment system.
- Understand the commercial end of the financial markets (e.g. those whose interests are aligned with a trading, transaction driven approach) and how this may be addressed.
- Analyse how the interests of asset owners can be better aligned with the need to strengthen the underlying sustainability of the economy.
- Analyse the influence that investment managers exert over fiduciaries and trustees.

Company disclosure

- Encourage stock exchanges to require companies in the coal, oil and gas sectors to report on the carbon dioxide potential of their reserves.
- Require companies to describe how their business model is compatible with a low carbon future.
- Encourage companies, perhaps as part of the discussion on integrated reporting, to explore and define the limits to their growth (e.g. how might limits on access to water affect business models).

Implementation

In the paper, the PRI provided a broad description of how it might take this area of work forward. The respondents and workshop and webinar participants offered a series of comments on this issue. Most of the comments related to the manner in which the PRI proposed financing this area of work.

Financing and other contributions

The paper stated: “High-quality work on the challenging issues outlined in this paper will in some cases require specialist consultancy and research support, over and above what can be provided by PRI’s own staff or budgets. The Secretariat therefore envisages that signatories interested in working on these issues will be invited to provide project-specific financial contributions to cover these costs... In the medium term it is hoped that PRI will be able to raise additional funding from other sources to support work of this kind (as well as other parts of our work). Potential sources include governments, international organisations and charitable foundations.”

This proved to be the most contentious point with many respondents and participants stating that they would not be willing to pay additional fees for this work. Representative comments include:

- *“We would recommend that the PRI stay within its existing budget given recent fee increases”*
- *“We note with some disquiet the intent of paragraph 3.6, which suggests that these projects would be likely to incur a fee for any participating PRI member... it seems surprising that these projects should not enjoy funding from the central PRI budget”.*

A number of respondents – broadly the same group that questioned whether addressing structural barriers to a sustainable financial system is a legitimate area for PRI activity – commented that signatory fees should be directed towards existing work by the PRI, not towards an expansion into lobbying and public policy. One response stated: *“In order to preserve the legitimacy and integrity of PRI as a global standard-setter within responsible investment we believe that the proposed work should: Be fully financially independent from the rest of PRI’s work and only be based on contributions made specifically to this work. Funds raised using the name and staff of PRI should be used for the good of all members, not for subgroups within PRI.”*

While relatively few commented on the proposal that the PRI seek external funding, some concerns were raised about the implications for the PRI’s work, with one respondent noting: *“Will funds be raised for existing projects and how much influence will external organizations have on PRI’s work? How will this affect the legitimacy of PRI’s work?”*

In relation to the contribution of signatories' time, there were expressions of interest but these were qualified by noting that interest would depend on the specific project/s to be taken forward. One respondent commented that the PRI should try to recruit a broad range of signatories to be involved in its work as, otherwise, the programme would be dominated by those signatories with the ability to contribute both human and financial resources.

Research or action?

A number of respondents and workshop participants expressed concern that the work programme would be overly focused on research. Two different issues were raised: the risk that the PRI simply duplicates or replicates research that has already been conducted by others (the risk of "reinventing the wheel" was identified by a number of respondents) and the risk that an emphasis on research would mean that the programme does not focus on outcomes or action. This argument was made starkly by one respondent who noted: "*The default assumption of the Consultation appears to be that the 'next step' on each of the major themes is to commission a research project or academic collaboration to obtain more data or depth of understanding on the topic in question... This is not to suggest that the on-going activities should progress without a sound evidence base - but rather that in most of the areas addressed by the Paper, that evidence base should already exist. The challenge then is to find ways to mobilise this existing data and develop influencing strategies to progress the agenda.*"

A number of respondents suggested the PRI's role could be less in terms of conducting new research and more in terms of collating and actively communicating existing research and best practices.

Signatory involvement

The paper suggested that projects would operate in the same way as existing PRI activities within Implementation Support and the Clearinghouse (i.e. by convening groups of interested signatories and facilitating collaborative activity, including commissioning research where necessary).

There was a divergence of views about which signatories should be involved. Some respondents suggested this area of work should be led by asset owner signatories rather than investment managers and service providers who may have conflicts of interest. Others disagreed and argued that the PRI should encourage involvement by all of its signatories .

A number of the respondents who argued that projects should be led by asset owners also emphasised the importance of ensuring that only one or two project areas are taken forward at any given time. If there are many different projects taking place at the same time, they expressed concern that asset owner involvement may be minimal, as asset owner signatories will be spread too thinly between projects creating the risk that they do not reflect their interests.

Branding

In the paper, the PRI stated: “Any recommendations for changes in investor practices or public policy that are developed through projects of this kind will be supported by detailed research. It will be made clear in publications produced in these projects and in public communication about these activities that these recommendations were developed by the PRI Secretariat in a consultative process with a range of signatories and experts, but that they do not necessarily reflect the views of the signatories as a whole or any individual signatory”.

A number of respondents expressed concern that the PRI’s work in this area would – notwithstanding PRI’s intention to make it clear that projects are only supported by a group of signatories and not the whole signatory base – mean that projects and outputs would be seen as ‘PRI projects’ (i.e. *defacto* endorsed by all PRI signatories), rather than as projects being led or driven by a small number of signatories.

Organisation

A number of respondents noted they faced significant resource constraints and would be unable to contribute significant time or resources to the PRI’s work. A number suggested that signatory input could be obtained by establishing a reference group (or expert advisory panel or project steering group) that meets at the beginning, in the middle and at the end of each project, with this group having an oversight role as well as responsibility for reviewing key documents produced by the project team.

One respondent suggested that participants in project steering groups should not only be those individuals with relevant expertise in the project area and prepared to devote sufficient time to oversee its development, but should also be organisations that are in a position to provide a test bed for the implementation of ideas within their own institutions.

Project selection criteria

In the paper, the PRI acknowledged that it needed to prioritise in order to make the most effective use of its resources, suggesting that it should focus on areas/projects that:

- Address the most significant strategic issues
- Have the greatest potential to make a significant difference to the development of a sustainable financial system
- Have the potential to deliver tangible outputs, with material benefits to investors, within a relatively short space of time
- Are particularly suited to PRI’s unique characteristics – its asset owner leadership, its depth of mainstream investment manager participation, its global reach and its link to the UN.

During the course of the consultation, the importance of having a structured prioritisation process was stressed by a number of respondents. While none of the respondents presented a complete framework, respondents pointed to the following as factors the PRI should consider when selecting projects:

- focus on the areas where the PRI – and its members – has the greatest leverage.
- focus on areas where the PRI can add value. One respondent suggested that the PRI should prioritise those areas where a ‘big push’ is required to enable progress to be made.
- focus on areas that align with investors’ interests.
- not replicate research that has already been done (e.g. on short-termism).
- identify low-hanging fruit/quick wins as well as longer-term projects.
- focus on investors, the role that investors can play and the actions that investors can take.
- not duplicate existing initiatives. Expressed another way, projects should meet an ‘additionality’ criterion (i.e. they should add value above and beyond what is already being done).
- focus on one or two projects, rather than seeking to take multiple projects forward at the same time.
- focus on areas where the PRI’s work leads to action, not research for the sake of research.
- focus on those areas where the PRI is clearly best able to speak with real expertise and facilitate its members collectively to speak with expertise, and so best able to be influential.
- focus on areas that are aligned with Principles.
- focus on supporting signatories in implementing the Principles.

Wider issues

While falling somewhat outside the strict scope of the paper, two wider issues were raised by a number of respondents.

First, a number noted that the PRI’s role is not simply to lead investors’ work in this area, but to act as a coordinator of research and opportunities in responsible investment. This could, for example, be done via bringing research to signatories’ attention, letting signatories know of new or developing initiatives and sharing best practice.

Second, a number pointed to the importance of the PRI ensuring that it delivers on its core work of implementing the Principles and, in particular, ensuring the effectiveness of its existing work programmes and activities before embarking on new areas of work.

3. Implications for the PRI

From the PRI's perspective, the main findings from the consultation are as follows:

The PRI's role

1. There is broad support among PRI signatories for the PRI to pursue a programme of work in relation to the strategic barriers to a sustainable financial system. However, taking work in this area forward must not be at the expense of existing projects and programmes (e.g. on reporting and assessment, implementation support, collaborative engagement).
2. It is important that the PRI focuses on those areas where it is clearly best able to speak with real expertise and where it can facilitate its members collectively to speak with expertise.
3. There are many ongoing projects on barriers to a sustainable financial system, many of which already have active investor involvement. It is important that the PRI does not duplicate research that has already been carried out, or seek to duplicate initiatives that are already established.

The areas of focus

4. There is broad support for the analysis presented in the paper, although the paper should have paid more attention to national policy frameworks and issues, and to the role that specific actors (e.g. the sell-side, credit rating agencies) play.
5. There is consensus among the consultation respondents that the single most important strategic barrier to a sustainable financial system is investor short-termism, with 92% of respondents identifying this issue as being relevant or highly relevant.
6. Other issues identified in the paper (company short-termism, portfolio structure, externalities, financial market stability, company disclosure and financing the sustainable economy) were all agreed to be important, with each being considered as 'relevant' or 'highly relevant' by between 65-80% of respondents, although with fewer than 50% of respondents identifying these as 'highly relevant'.
7. The majority (74%) of respondents expressed interest in contributing to projects on investor short-termism, with portfolio structure and strategic asset allocation (53%) and company disclosure (50%) also of interest to many respondents.

Specific projects

8. In total, over 60 different potential project areas (or potential areas for research and investigation) were identified by respondents. However, there was no consensus on which of these were the most appropriate for the PRI to take forward.
9. Concern was expressed that the work programme would be overly focused on research, rather than on outcomes or action.
10. Respondents stressed the importance of the PRI having a structured process for the selection of project areas, and a number offered suggestions on the factors the PRI should consider when deciding which projects it should take forward.

Implementation

11. The general approach to implementation proposed by the PRI in the consultation paper (i.e. with the PRI convening group(s) of interested signatories to work on and oversee projects) was broadly supported.
12. Many respondents do not think that PRI signatories should be required to pay additional fees to support this area of work. A number also raised concerns about the implications of seeking or obtaining funding from other sources for this area of work.
13. A number of respondents expressed concern that the PRI's work in this area could be seen as 'PRI projects' (i.e. *de facto* endorsed by all PRI signatories), rather than as projects being led or driven by a small number of signatories.
14. Respondents noted that PRI's role in this area is not simply about leading investors' work but also bringing research to signatories' attention, informing signatories of new or developing initiatives and sharing best practice.

The consultation has pointed to the importance of this new programme of work for the PRI. It is clear that the PRI's work to address strategic barriers to a sustainable financial system will need to encompass our existing work and projects on addressing these barriers (e.g. sustainable stock exchanges), our contribution to other initiatives in this area (e.g. ongoing support for work on integrated reporting), our role as a provider/distributed of information, and our role as a thought leader. Much of our existing work already contributes to addressing these barriers, not least the PRI Principles around active ownership, collaboration and transparency, and much of our implementation support program.

4. Next steps

The consultation has not provided the PRI with a definitive answer of where to begin this new work programme or how to prioritise the options that are available to us. The PRI has established an advisory committee, made up of representatives from signatory organisations and other individuals recommended for their expertise in this area by members of the PRI Advisory Council and PRI Association Board (see Appendix 2 for a full list of members).

The advisory committee will help the PRI to:

- Define the criteria (or factors) that it should consider in prioritising potential project areas.
- Develop a short-list of potential initial projects and prioritise this short-list using the prioritisation criteria.
- Advise the PRI on appropriate strategies for managing the implementation risks and other issues identified in the course of the consultation.
- Advise how to best leverage collaborations with other organisations.

The committee's role is expertise-based and advisory, not governing or decision-making. Formal sign-off for any projects will rest with the PRI Executive, PRI Advisory Council and PRI Association Board.

The PRI will also host further meetings with signatories in Paris in August, hosted by CDC, and in The Hague in September 2013, hosted by PGGM and MN Services. The agenda for these meetings has not been finalised however we expect discussions to focus on the consultation findings and potential next steps.

Following feedback from the advisory committee, the PRI will prepare a briefing note for the PRI Advisory Council to outline how it intends to take its work in this area forward. A summary of this briefing note and the discussions and decisions of the PRI Advisory Council will be presented at PRI in Person in Cape Town in October 2013. This will provide an opportunity for signatories to hear more about the proposed programme of work and register their interest in participating.

Appendix 1: List of organisations that responded in writing to the consultation

Asset owners	Investment managers	Service providers / other stakeholders
1. 30 VP	29. 21 Partners	57. Australian Council of Superannuation Investors (Note 2)
2. Allianz SE	30. Addenda Capital Inc.	58. CAER - Corporate Analysis. Enhanced Responsibility.
3. ATP (see Note 1)	31. Azulis capital	59. Carbontracker
4. Church of Sweden	32. BB DTVM Gestão de Recursos	60. EIRIS
5. CPP Investment Board	33. BC Investment Management Corporation	61. ESG Analytics
6. CWC	34. Blue Wolf Capital	62. GES
7. Danske Bank (Note 1)	35. DLM Invista Asset Management	63. ICWords (Academic)
8. FASERN Fundação Cosern de Previdência Complementar	36. Domini Social Investments	64. IRRC Institute (Academic)
9. Groupe Caisse de Dépôts	37. F&C Investments	65. Mercer
10. Industriens Pension (Note 1)	38. FIR Capital Partners	66. Novaster
11. KfW Bankengruppe	39. Generation IM	67. onValues
12. LD (Note 1)	40. Governance For Owners	68. Regnan
13. LocalTapiola Pension	41. Hermes	69. SRI-CONNECT
14. London Pensions Fund Authority	42. Industry Funds Management	70. UKSIF
15. Municipal Pension Plan	43. La Française AM	71. Vigeo
16. New Zealand Superannuation Fund	44. Mn Services	72. Vlerick (Academic)
17. Norwegian Ministry of Finance	45. Natixis Asset Management	
18. PFA Pension (Note 1)	46. NEI Investments	
19. PensionDanmark (Note 1)	47. Northward Capital	
20. PKA (Note 1)	48. Pax World Management LLC	
21. Sampension (Note 1)	49. Rabo FARM	
22. SEIU Master Trust	50. Schroders	
23. Swiss Re Ltd	51. Standard Life Investments	
24. TY Danjuma Family Office Ltd	52. SUSI Partners AG	
25. Unison Staff Pension		

Scheme	53. SWIP
26. USS	54. Threadneedle
27. VicSuper	55. UCA Funds Management
28. Zurich Insurance Company	56. Votorantim Asset Management

Note 1: ATP, Danske Bank, Industriens Pension, LD, PFA Pension, PensionDanmark, PKA and Sampension provided a joint submission.

Note 2: ACSI represents 32 Australian superannuation funds.

Appendix 2: Strategic barriers advisory committee members

- Jane Ambachtsheer, Mercer
- H el ena Charrier, Caisse des D ep ots
- Stephen Davis, Harvard University
- Danyelle Guyatt, Catholic Super
- Johan Mellerup, ATP
- Paul Murphy, ACSI
- Fagmeedah Petersen Lurie, Eskom Pension & Provident Fund and GEPF South Africa
- Raj Thamotheram, Raj Thamotheram Associates
- Ed Waitzer, Stikeman Elliot
- Steve Waygood, Aviva Investor