RPMI RAILPEN

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Via email: commentletters@ifrs.org

RPMI Railpen (Railpen) response to IFRS Foundation's *Consultation Paper on Sustainability Reporting*

About Railpen

RPMI Railpen (Railpen) acts as the investment manager for the Railways Pension Schemes, and is responsible for managing c. £30 billion of assets. Our mission is to pay the pensions of our 350,000 members securely, affordably and sustainably. Railpen is authorised and regulated by the Financial Conduct Authority (FCA). As an investment manager acting for one pension scheme client, Railpen undertakes responsibilities attributed to asset owners and asset managers. Unlike many UK Defined Benefit (DB) schemes, the Railways Pension Schemes include many open DB sections, which means that the Trustee expects to be paying the pension of an eighteen-year-old who is in their first job today out to 2100 and beyond. As a result, Railpen invests for the long-term.

This response to the IFRS Foundation's consultation paper is authored by RPMI Railpen, and we have answered the issues raised in the consultation paper in a way which reflects the breadth of our responsibilities.

Our response

The purpose of our investment activities is to provide to our members a secure retirement income for many decades to come. As a result, we include environmental, social, and corporate governance (ESG) factors in our investment processes, and have done so for a considerable period of time. In doing so, we act in alignment with the investment beliefs of our Trustee Board. At the present time, the identification and pricing of ESG risk is a more difficult, costly, and imprecise activity than it needs to be. As a result we support, in principle, the IFRS Foundation's proposal to form a Sustainability Standards Board (SSB), as this would likely improve standardisation and increase data coverage, and thereby make ESG integration less costly and more precise. Our support comes, however, with certain reservations which we note below.

Governance

Investors, including pension funds, should be included in the governance structure of the SSB. The fundamental purpose of capital markets is to connect capital providers (e.g. investors) with capital users (e.g. corporates), and the role of corporate disclosure is to make the investor's capital allocation decisions efficient. When capital markets function efficiently, investors are able to meet their client's financial objectives, such as providing retirement income.

When it comes to ESG factors, long-term investors ought to attend to two types of risk: idiosyncratic risk and systemic risk. Each type of risk can affect financial outcomes. Idiosyncratic risk is specific to an individual security, or a reasonably discrete set of securities; it can in general be mitigated by not holding

a particular security, or by holding a diversified basket of securities. Systemic risk relates to issues that have the potential to affect all securities (all asset classes, sectors, regions, styles, etc); by definition systemic risk cannot be prevented by diversification alone.

ESG disclosure by corporates (and other users of capital) ought to be designed so as to assist long-term investors in attending both to idiosyncratic and systemic risks. Pension fund investors are perfectly placed to support this endeavour and should therefore be included in the SSB's governance structure.

Climate first vs ESG first

Question 8 in the consultation paper considers whether the SSB should focus on only climate-related risks. The SSB should, from the outset, consider both climate risks and broader ESG risks for two reasons: (i) materiality and (ii) unintended consequences.

For some business models, climate-related risks (or opportunities) might be the most material ESG factor, but this is not always the case. For some industries, ESG issues other than climate change are more material, and information pertaining to broader ESG issues is likely to be of greater utility to an investor.

Focussing on one issue to the exclusion of others can create unintended consequences. "ESG risk" captures a range of risk types that are related to one another. Climate risk, for example, is related to workforce issues, human rights, water scarcity, sustainable food production, responsible technology, governance, and more. If we accept that disclosure is linked to action, then requiring issuers to disclose only on climate issues (or providing issuers with incentives to converge to some sort of lowest common denominator) could lead to actions that do not appropriately consider the interrelation between risk types. The SSB should from the outset consider the gamut of ESG risk types, not just climate-related risks.

Building on existing intelligence

As you know, there are credible standard setters already directing corporate disclosure on sustainability issues. The so-called "group of five" standard setters published in September 2020 a Statement of Intent to work together for greater alignment. IOSCO, EU institutions, the UN, and leading open-source tools such as the TPI provide essential additions to the work of the standard setters. It would make no sense at all for the SSB to start from scratch when so much intelligence has been developed by others. We recommend the IFRS Foundation partner with these credible players so as to (a) utilise the intelligence and expertise available and (b) prevent ongoing fragmentation in sustainability disclosure standards.

Double vs single materiality

We refer to our definitions of idiosyncratic and systemic risks above. It is possible for a company to manage or mitigate all its idiosyncratic risks, and yet still contribute to systemic risks. For example, the company might operate in a market that does not intend to regulate certain externalities, or where the price of those externalities is immaterial, or the company might be able to fully insure its risks. An investor in such a company might bear no material idiosyncratic ESG risk.

However, as long as this company, and a sufficiently large set of other companies, continue to create negative externalities then this creates systemic risk for the long-term investor *whether they are invested*

in this particular company (or the set of companies) or not. Therefore the long-term investor is interested in a broader set of ESG data than that which deals only with the priceable risks to which the investor's particular assets are exposed.

In a perfect world, the SSB would create appropriate disclosure standards for both "outside-in" materiality (which supports the assessment of idiosyncratic ESG risk) and "inside-out" materiality, or "impact" (which supports the assessment of systemic ESG risk), and do so with alacrity. In a perfect world, therefore, the SSB would from the outset design standards that attend to "double materiality"[1].

It has been recognised by some that addressing double-materiality in disclosure standards would take more time than just focussing on single (outside-in) materiality. It would be pragmatic for the SSB to perform a scoping exercise to determine whether there would indeed be such a time implication, and if so of what magnitude. Ideally the SSB's disclosure standards should attend to double materiality from the outset, but not at the risk of delaying single (outside-in) materiality standards by, say, two years. Such a scoping exercise should explore the use of existing frameworks and the time saving accrued by doing so.

ESG has become a highly competitive market for investors, companies, data providers, index houses, even NGOs. Whichever standards the SSB arrives at, some actors will always have an incentive to go a bit further. If the SSB becomes the go-to standard for single materiality, the competitive space will shift to "inside-out" materiality, or "impact". The SSB can play a role in minimising the future fragmentation of impact disclosures either by tackling double materiality from the outset, or by laying out a road-map to do so in the near term.

If the SSB resolves to focus only on single (outside-in) materiality, we recommend drawing heavily on the work of SASB (now the Value Reporting Foundation), which seems tailor made for the enterprise suggested in the consultation paper.

Some important features of sustainability disclosures

We encourage the SSB to bear the following features in mind:

- Sector specificity: ESG risk is highly sector specific, and disclosures should reflect this. We recognise this might be an area where the IFRS Foundation needs to seek outside expertise.

- Cross-regional consistency: IFRS is used in 144 jurisdictions, and current ESG disclosure standards vary geographically. Regional variation in ESG disclosures should only be indulged to the extent that it makes sense for the users of the disclosures. We would encourage the SSB to set the most appropriate ESG disclosure standards regardless of local requirements; the issuers would provide supplementary disclosures as required for their local laws, regulations, or listing regime.

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[1] "Outside-In" materiality refers to the potential for environmental or social factors, which might be currently be external to a company, to come to be internalised through regulation, taxes, higher costs, substitution effects, consumer preferences, litigation, or other means. It is the transition of external factors into internal factors through some sort of crystallisation event. "Inside-Out" materiality refers to the potential for a company's business activities to impact the environment or society, independently of whether such impact is, or is likely to be, of material financial concern to the company. "Double materiality" refers to both "Outside-In" materiality and "Inside-Out" materiality. In this document we refer to "Single materiality" as "Outside-In" materiality only.

- Metrics: risks should ideally be priced. We recommend the requirement for issuers to disclose industry-specific quantitative metrics, alongside relevant qualitative information.

- Auditability: disclosures should be auditable, but care should be taken around unintended consequences. The focus on auditability should not be such that important ESG disclosures are discarded because third-party firms find such disclosures challenging to verify, or because company management teams are risk-averse and so choose not to subject themselves to additional auditable information.

- Language, definitions, and consistent terminology are mission-critical: “Material”, “ESG risk”, “Non-financial”, and “sustainability” need to be used clearly and consistently, and long-term investors should define these concepts.

Conclusion

The provision of ESG data needs to become more relevant, complete, consistent, and cheaper to access. The IFRS Foundation has the ability to make this happen, and we are supportive in principle of the creation of the SSB. Pension funds should be included in the governance structure of the SSB; existing disclosure standards should be used as building blocks; double-materiality should be attended to, and; ESG risks (not just climate risks) should be considered from the outset.

We hope that the views we present here have been helpful. We would welcome the opportunity to continue the conversation – please contact contactus@rpmi.co.uk if you would like to do so.

Yours faithfully,

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