Pension Notes

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Progress of Sustainable Investment in the Latin American Pension Funds

Federación Internacional de Administradoras de Fondos de Pensiones

Executive Summary

Sustainable investment is about creating economic value through environmental awareness, respect for human rights, and good corporate governance. By integrating Environmental, Social and Corporate Governance (ESG) criteria, and those related to climate change into the investment process, it seeks to promote better decision-making, achieving a better risk-return ratio. It thus helps investors make more informed and ethical decisions, while generating a positive impact on society and the environment, contributing to the creation of a more sustainable and equitable world.

Latin America is at a historic moment in the construction of the sustainable investment ecosystem, due to two major trends. First, the growing interest in sustainable investment by the pension funds in individual savings systems: Pension Fund Managers in the Latin American region are mostly aware of their responsibility for long-term investment for the benefit of their members, and understand that incorporating ESG factors into the investment process helps allocate capital to well-governed companies working to create sustainable economies, consistent with the global understanding that fiduciary duty considers these factors. Second, the growing adoption of drivers for boosting ESG, such as public-private partnerships in sustainable finance, the development of "green taxonomies" (which enable differentiating and classifying instruments of this type) at the local level, and the development of regulations and/or initiatives that enable establishing the terms, conditions, and incentives for the proper development of ESG (for example, the rules that require incorporating ESG factors into the investment and risk management policies of Pension Fund Managers).

The countries currently most advanced in the integration of ESG factors into their pension systems are Brazil, Chile, Mexico, Colombia and Peru. Despite all the progress made, many improvements are still pending for the full development of ESG in the financial system, particularly in the pension fund sector, and the Latin American Pension Fund Managers are committed to continuing on this path. These include, for example, establishing clear and standardized global regulations for promoting the incorporation of ESG factors in the transactions and investment strategies of all financial institutions, providing training programs for all financial institutions (including the risk and investment teams of Pension Fund Managers) so they can understand, adopt and effectively implement ESG practices, continuing to encourage issuers (companies listed on the stock exchange) to report ESG-related data aligned with global methodologies, in a standardized manner, while achieving greater standardization of available data and methods (e.g. evaluation metrics) for the analysis of assets related to ESG criteria, avoiding "greenwashing".

Introduction

This Pensions Note addresses the importance of sustainable investment, understood to be Environmental, Social and Corporate Governance (ESG) factors in investment processes. Secondly, it reviews the overall progress in these matters in the region, identifying the main trends and drivers of the individually funded pension savings system, and the financial system in general. Thirdly, it briefly reviews the Latin American pension systems most advanced in the integration of ESG factors, describing their main milestones and the rules and regulations introduced over time. Finally, the note concludes with the pending measures required for advancing in the successful implementation of ESG in the financial system, and particularly in the pension fund sector.

I. Sustainable investment and its importance

Sustainable investment is about creating economic value through environmental awareness, respect for human rights, and good corporate governance[1]. By integrating these Environmental, Social and Corporate Governance (ESG) criteria into the investment process, it seeks to promote better decision making to achieve a more balanced risk-return ratio.

The Environmental factor generally focuses on averting air and water pollution, fighting against climate change, reducing greenhouse gas emissions, energy efficiency, respect for biodiversity, and the use of renewable energy, among others.

The Social factor usually prioritizes achieving or maintaining social stability through matters related to human health, education, human and workers' rights, among others.

Finally, the Corporate Governance criteria refer to the quality of management in companies and their organizational culture, seeking to ensure that decision-making is carried out in a transparent manner, considering the interests of all parties involved.

To understand why ESG factors should be considered in investments, one must bear in mind that sustainability and returns are perfectly compatible. In fact, failure to consider sustainability will impact future returns. Sustainable investment in companies with adequate ESG assessment results in stronger and more consistent results over time, especially in the long term. Sustainable

investment was previously considered not profitable, but that trend is changing, and more and more private and institutional investors (such as pension funds) are looking for investment assets and products that meet the ESG criteria, thus obtaining returns while contributing to improving one or several factors.

In short, sustainable investment is important because it seeks financial returns while considering ESG criteria. Sustainable investment helps investors make better informed and ethical decisions, which have a positive impact on society and the environment, contributing to the creation of more sustainable and equitable conditions.

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[1] For further information, see "Sustainable investment in pension funds – ANAFAP – March 2023"

II. Progress on sustainable investment in the Latin American region

The global financial ecosystem has faced unprecedented challenges and uncertainties in the last two years. Amid a global pandemic and the Russian invasion of Ukraine, more and more institutional investors in Latin America have enhanced their understanding of investment focusing on ESG factors.

Thus, for example, the growth of the Principles for Responsible Investment (PRI) has highlighted this trend, as it recently surpassed the milestone of more than 5,000 signatories with more than USD 100 trillion in Assets Under Management (AUM) globally. PRIs have been present in the region since 2010, starting in Brazil, and advancing their mission to contribute to the expansion of responsible investment in Latin America since 2018.

We are at a historic moment in the construction of the sustainable investment ecosystem in the Latin American region, which will undoubtedly be consolidated in the mid and long term. The above, in FIAP's opinion, is due to two major trends:

(i) The growing interest in sustainable investment by the Pension Funds in more mature individually funded savings systems

A point worth mentioning in the growth of PRIs in the Latin American region is the role of the Pension Funds (AFPs, AFAPs, AFORES, etc.), which have been key allies, acquiring commitments to integrate ESG factors into pension fund investment decisions.

For the most part, the Pension Fund Managers in the region are aware of their long-term investment responsibilities for the benefit of their members and understand that incorporating ESG factors into the investment process helps allocate capital to companies with good corporate governance working to create sustainable economies, consistent with the global understanding that their fiduciary duty must consider these factors. Thus, the incorporation of ESG factors in their investment decisions has become a practice that enables them to better manage their members' savings and, in turn, contribute to the development of more sustainable economies.

Following on the above, there are already 18 Pension Fund Managers in the region that have subscribed to the PRIs, thereby undertaking to make investment decisions considering the ESG criteria implemented in 7 countries: Chile, Colombia, Costa Rica, Mexico, Peru, the Dominican Republic and Uruguay.

(ii) The growing adoption of ESG drivers

Several countries in the region have recently adopted these types of drivers, such as, for example:

a. **Public-private partnerships in sustainable finance:** The establishment of these types of public-private partnerships has become increasingly common among governments, financial authorities, supervisors, central banks and representatives of the financial and pension sectors for creating platforms that serve as spaces for the exchange of knowledge and experiences in terms of best practices and the integration of ESG aspects in financial and investment decisions. Some examples are Chile's "Public-Private Board of Green Finance" (of 2019), Colombia's "Responsible Investment Task Force" (2019), or Mexico's "Network for Greening the Financial System" (2017) and the "Sustainable Finance Committee" (2020). These partnerships have been catalysts for important sustainability initiatives, such as the Green Agreements/Protocols or sustainable taxonomies.

b. **Development of green taxonomies or sustainable finance at the local level** (currently being developed in Brazil, Chile, Peru and the Dominican Republic, and already in effect in Colombia, Costa Rica and Mexico). These taxonomies are classification tools that facilitate the differentiation and classification of financial instruments referred to as "green" or "sustainable", thus creating a common guide or language that facilitates the comparison of alternatives, provides transparency and avoids *Greenwashing*[2] in the financial market,

   It is also worth mentioning that UNEP FI published the new "**Common Framework of Sustainable Finance Taxonomies for Latin America and the Caribbean**" in July this year[3], which is an excellent initiative because it serves as a voluntary reference for countries that are in the process of developing sustainable finance taxonomies, or intending to do so, establishing similar guiding principles and classification systems for comparable sectors and activities, aligning with the principles established by the G20 Sustainable Finance Working Group and other taxonomies developed globally.

c. **Development of regulations/initiatives that enable the establishment of terms, conditions and incentives for the proper development of ESG**, such as:

   - Those issued by Pension Supervisors regarding the incorporation of ESG factors into the investment and risk management policies of Pension Fund Managers (as in Chile, Colombia, Mexico and Peru).
   - Those requiring disclosure of the sustainability and corporate governance measures taken in the reports of issuers of publicly-listed securities (e.g. Chile).

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[2] Greenwashing refers to projecting a company's image as sustainable, even if its activity affects the environment and does nothing to remedy it.

[3] https://www.unepfi.org/publications/common-framework-for-sustainable-finance-taxonomies-for-latin-america-and-the-caribbean/

- Those that enable the development of a single data instrument for the pension fund management sector, for the issuers to respond. With this tool, pension fund managers will have access to authorized information from which they will define their ESG analysis models (recent example: Mexico, with its "Homologated ESG questionnaire").

Despite all the progress in the region, there are still many challenges, such as access and standardization of information related to ESG, alignment of investors in the criteria to be observed in their investments, construction of knowledge and capacities to incorporate ESG, among others.

III. A review of the Latin American pension systems most advanced in incorporating ESG factors into pension fund investment

The countries currently most advanced in the integration of ESG factors into their pension systems are Brazil, Chile, Mexico, Colombia and Peru. We briefly refer to each one of these systems below.

Brazil

Brazil has been working on sustainable finance for more than 10 years, after it established the Green Protocol and the framework for the creation and implementation of a social and environmental responsibility policy.

ESG is definitely on the agenda and the pension funds see it as a priority and a mandatory compliance item. The supervisory body PREVIC has indicated that it will seek to promote ESG guidelines with the supervised agencies. Institutional investors are becoming aware of the importance of positive and negative investment filters for the proper development of an ESG culture.

Some significant recent milestones are:

- 2009: Investment policy statements were required to include socio-environmental responsibility principles.
- 2018: ESG factors should be consider in the investment risk analysis, where possible.
- 2019: The appointment of investment managers must comply with self-regulatory and ethical codes, encouraging good market practices, transparency, etc.
- 2020: The Best Practices Guidelines were updated with a section on how to comply with ESG-related regulations.
- 2021: A Survey on the use of ESG in the analysis of investment risks was conducted among the EFPCs (Closed Complementary Pension Agencies).
- 2023: In consultation with organized civil society, 17 topics were selected from a Ministry of Finance agenda called "**Financial Reform Agenda,**" to be prioritized by the Federal Government. One of the selected topics was “ESG Financial Instruments,” which aims to: “Create financial instruments and products that meet and align with the Green transformation and ESG agenda. The mechanisms will seek to channel significant investments towards initiatives aimed at protecting the environment, improving social conditions and promoting good governance practices." This initiative will benefit investors, the economy and the environment.

Chile

Chile has not lagged in advancing towards best practices and standards. Either through adherence to the Sustainable Development Goals (SDGs) of ESG management, or driven by the new standard[4] which requires the disclosure of sustainability and corporate governance measures in the reports of issuers of publicy-listed securities, companies are becoming aware of the importance of strengthening practices in ESG matters.

According to the Chilean Association of Pension Fund Administrators (AFPs), the AFPs are addressing this challenge primarily via three mechanisms[5]:

1. **From a governance and social perspective, AFPs have made efforts to incorporate gender inclusion and equity in several areas**. Thus, the latest Report on Gender Indicators of Chilean Companies, published by ChileMujeres, the ILO and the Ministries of Finance, Economy, Development, and Tourism, revealed that by the end of 2022, all the Fund Managers in the Chilean Association of AFPs had more than 50% of female staff, between 14% and 43% of women in senior management, and 4 out of 6 Fund Managers already have women on their Boards. There is still a long way to go, but change is already a reality.

   Meanwhile, another area in which the Fund Managers intend to promote female inclusion is in the establishment of the register of candidates for directors of companies. Being on this list, managed by the Superintendency of Pensions, is a requirement to be able to be elected a candidate by the Fund Managers.

2. **AFPs thoroughly examine the risks associated with their operation and functioning**. There are a series of situations that must be foreseen in the management of pension savings, whether in the field of investment management, attention to imembers and security and privacy of information.

3. **Sustainable investment is advancing among AFPs**. The Pension Commission has incorporated ESG factors[6] in the risk management and investment process of pension savings. The regulator also obligates the AFPs to encourage the disclosure of information on risk assessment related to climate change in companies and SPVs where pension savings are invested.

[4] General Standard No.461. This standard makes it mandatory for Chilean public companies to incorporate sustainability and corporate governance practices in their annual reports, in accordance with the standards of the Sustainability Accounting Standards Board (SASB). The gradual implementation of these regulations has led companies to include sustainability factors in their 2022 reports, improving transparency and providing investors with relevant data for investment analysis.

[5] https://www.aafp.cl/gestion-esg-un-compromiso-que-toma-fuerza-entre-las-administradoras-de-fondos-de-pensiones/

[6] General Standard No. 276. This regulation requires reporting on environmental, social, corporate governance and climate change risks and factors considered in investors' investment decisions. This regulatory requirement incentivizes major market players, such as Pension Fund Managers, to promote ESG incorporation and transparency.

Regarding the aforementioned advance of sustainable investment among pension funds, it is especially important to mention that the Superintendence of Pensions of Chile in 2020 published a new rule that establishes a series of instructions to the AFPs and the AFCs (Administrators of Unemployment Funds), with the aim of incorporating climate risk and the so-called ESG factors both in their investment policies and processes, as well as in their risk assessment and management activity. The objective of the rule is to guarantee adequate management of members' pension savings. In this sense, the new General Standard No. 276[6] of 2020 indicates that administrators must specify how these elements are incorporated into the investment analysis processes carried out by their respective teams.

It is instructed that AFPs must adapt their technical capabilities to guarantee correct management of people's pension savings under this new perspective, which goes beyond traditional financial risks.

The best international standards issued on the subject are taken as a reference, thus being framed among the initiatives and improvements that are a central part of the so-called “Green Agreement” that in December 2019 was signed by the Superintendency of Pensions, the Ministry of Finance, the Commission for the Financial Market (CMF), the Central Bank and representatives of the financial and pension sector.

This voluntary commitment between the government, regulators and the financial and pension sector defines the general principles regarding the management of risks and opportunities associated with climate change in decision-making.

Among the new obligations are:

- AFP boards must explicitly consider climate risk and those matters associated with ESG factors as relevant financial risks.
- The boards of directors must document how they will consider climate risks and those matters associated with ESG factors.
- Incorporate climate risk and risks associated with ESG factors into the risk assessment.
- The investment policies of pension fund administrators must consider climate and ESG risks in the investment and risk management processes.
- With the objective of achieving adequate integration of climate and ESG risks in the investment and risk management process, pension fund administrators must allocate the necessary resources to generate technical capabilities in the teams in charge of this work.
- AFPs must incorporate into their investment policies, particular metrics to measure the impact of climate change on the investment decisions of pension funds.
- AFPs must incorporate in communications to their members information regarding how climate and ESG risks are being considered in investment policies.
- AFPs must promote the disclosure of information on how they evaluate risks related to climate change and ESG in the companies and vehicles where they invest pension fund resources, and the adoption of good practices in the matter.

According to the Chilean Association of AFPs[7], currently at least 70% of the pension fund portfolio is covered by ESG and climate change criteria. Regarding the challenges, it mentions that these are related to advancing in further incorporation of those criteria in local small caps companies, transitioning to the use of more standardized metrics to facilitate comparison, and that the information reported by issuers is enhanced in a common format and in digital form so that investors can make a more efficient use of reports.

[7] https://www.aafp.cl/gerente-de-estudios-abordo-los-desafios-de-la-industria-de-las-afp-para-implementar-criterios-esg/

Mexico

This country is developing strategies to consolidate a financial system that enables funds to be allocated in investments that result in positive environmental and social impacts. There has been considerable progress in this regard, particularly with the creation of the Sustainable Finance Committee (2020), which has been working on designing an agenda to transition towards the sustainability of the financial system. The Committee's first great achievement was the development of the "Sustainable Taxonomy of Mexico" (publishing the first edition in March 2023), which provides a reference framework for identifying and classifying economic activities that contribute to the achievement of environmental and social objectives. In turn, sustainable financing has been promoted through the issuing of labeled instruments, specifically focusing on "Thematic Bonds," with their respective reference frameworks. In this regard, Mexico has been at the forefront by issuing the First Reference Framework for Sovereign Bonds Linked to the UN Sustainable Development Goals, in 2020.

Governments, corporations and investors, in general, are starting to integrate ESG factors into their operations and investment decisions. At the governmental level, environmental regulations have been implemented and policies have been established to address social and corporate governance issues. Likewise, investors, particularly Pension Fund Managers (AFORES), are being asked to integrate ESG factors into their investment strategies. Moreover, several financial institutions are working to adopt and report ESG measures as part of their business strategy.

The following are some of the most relevant sustainable investment milestones in the AFORES sector:

a. In July 2020, the Mexican Association of Pension Fund Managers (Amafore) created the Responsible Investments Subcommittee, whose main purpose was to design a work procedure that would allow the Afores to adopt ESG standards without them being intrusive in their investment processes.

b. In 2021, new regulations were issued for the mandatory inclusion of ESG factors, requiring policies for management and exposure to environmental, social and governance risks in pension fund investment portfolios. The analysis of the inherent characteristics and risks must also include reviewing the compliance of issuers with these criteria.

c. In September 2022, a new provision was published regarding the obligation to have ESG-certified personnel, which includes risks and opportunities related to climate change, in order to manage their impacts on investment portfolios (this new regulation will come into effect at the end of September 2023).

d. Finally, in order to streamline efforts for the integration of ESG factors in the pension funds investment process, AMAFORE's Responsible Investments Committee prepared an "Approved ESG Questionnaire for Issuers" in the third quarter of 2022, This questionnaire aims to collect and unify, under the same criteria, the information related to progress in ESG matters of the issuers in which the Fund Managers invest, or could invest. The document was prepared by compiling and unifying the questions and indicators of the different questionnaires of the AFOREs, as well as the most important international standards in terms of sustainability. At the end of June 2023, AMAFORE announced that the national public issuers are already working on completing the questionnaire, and after the evaluation of this initial response, it intends to publish the list of companies that successfully meet these criteria.

Peru

In 2017, the Pension Regulator began incorporating ESG factors into the pension funds investment process, issuing the first provisions aimed at strengthening the fiduciary responsibility of AFPs to their members. Subsequently, in 2021, another standard stipulated the inclusion of ESG factors in the structure of investment policies, whereby the AFPs must stipulate the inclusion of ESG risk factors in their portfolios, types of assets or instruments and investment transactions in the investment risk policies and procedures manuals, and periodically evaluate the impact of the integration of ESG factors in the portfolio risk profiles, in accordance with the policies and procedural manuals defined by the AFPs.

Should an AFP decide to integrate ESG factors into its investment process, the policy must contain at least the following aspects: purpose, scope, fiduciary responsibilities that guide the AFP and attribution of responsibilities for compliance with the policy. Should an AFP decide not to integrate these factors, it is required to stipulate the reasons for its decision in its policies and procedures, for the sake of transparency of information with its members.

To date, most AFPs have completed the process of including the integration of ESG factors in their investment policies, manuals and procedures. 3 AFPs in the system have also adhered to the United Nations Principles for Responsible Investment, whereby they commit to considering ESG criteria when making investment decisions. This allows them to improve long-term returns, reduce risks and adapt to global regulatory trends, with a positive reputational impact.

Colombia

Colombia has made significant progress in creating a regulatory environment conducive to sustainability. In fact, the World Bank acknowledged that the country has taken important steps to transform its intentions into action, such as the development of a local Green Bond Market and a Green Taxonomy; the integration of sustainability and environmental and social governance, as well as guidelines for the financial and infrastructure sector.
Some significant recent milestones are:

- 2012: The Green Protocol, a voluntary initiative led by Asobancaria and the National Government, was established.
- 2016: The first Green Bond was issued.
- 2018: The 2018-2022 National Development Plan introduced policies and plans providing guidance regarding the sustainable development of the country. A survey on climate change risks and opportunities was also conducted.
- 2019: Regulations governing the disclosure of social investment of financial, insurance and stock market agencies was established.
- 2020: Regulations governing the integration of ESG factors into the investment objectives of the AFPs were introduced. Regulations requiring meteorological measurement data and strategies to explain ESG allocation in voluntary funds, were also issued. In July of that year the Responsible Investment Task Force issued a declaration in favor of responsible investment in Colombia.
- 2021: A Technical Document on ESG Disclosure was published.
- 2022: Regulations were published acknowledging the need to move funds from the financial system to capital investments that apply ESG criteria and practices, announcing the Green Taxonomy of Colombia, which identifies the activities and assets that contribute to the country's environmental objectives, acting as an exploratory tool for shareholders/investors.

IV. Steps required for advancing the development of ESG factors in the region

Based on what we have learned from the recent experiences of different countries regarding ESG matters, FIAP believes that there are several necessary aspects in which further progress must be made for the proper development of ESG in the financial system, particularly in the pension funds sector. Among the most important are the following:

i) Establish clear and standardized regulations that promote the incorporation of ESG factors in the transactions and investment strategies of all financial institutions.

ii) Provide training programs so that all financial institutions (including the risk and investment teams of Pension Fund Managers) can understand, adopt and effectively implement ESG practices. This could include collaboration with international organizations and sustainability experts.

iii) Promote the disclosure of ESG data by all financial institutions.

iv) Disseminate information on sustainable finance throughout society, since correct understanding of ESG concepts is required. It is also crucial to raise awareness about the impact of integrating ESG factors into financial results and long-term sustainability.

v) Continue to incentivize issuers (companies listed on the stock exchange) to report ESG-related data aligned with global methodologies[87], in a standardized manner, to facilitate the task of evaluating the information provided by institutional investors (including Pension Fund Managers).

vi) Involve more companies, at a Board level, to adopt sustainable strategies based on ESG criteria. Although large companies have started adopting them, this usually does not transcend to smaller companies.

vii) Greater standardization of available data and methods (e.g. evaluation metrics) for the analysis of assets related to ESG criteria, avoiding "greenwashing".

viii) Encourage the development of more thematic fixed income instruments that are issued locally (green, social, sustainable bonds or linked to the fulfillment of certain sustainability objectives) that enable the promotion of long-term investment in the economy and help channel resources towards projects that facilitate a sustainable development model (Mexico is the best reference in the region in this regard).

[8] Such as IFRS S1 and S2, SASB and TCFD.

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