PRI's Approach to System-level Risks

—— Discussion of TIIP's "System-Level Investing" ——

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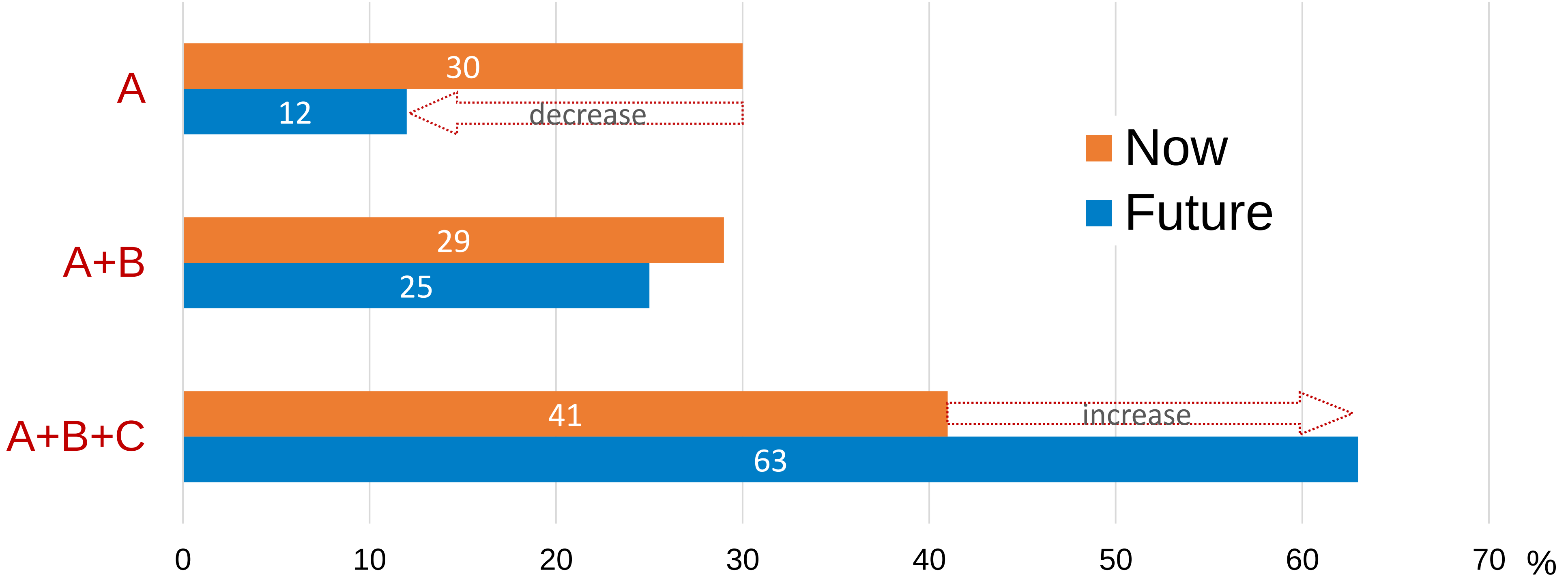
Investors Foresee Increased Action

At my organization, responsible investment is:

A. Managing **ESG risks**
Using ESG information to assess risk to holdings within the portfolio, and adjusting the exposures

B. Identifying real-world sustainability outcomes
Reviewing or mapping portfolios in terms of how aligned or not they are with different SDGs

C. Taking action on **sustainability outcomes** in the real world
Seeking to shape outcomes linked to a specific SDG by using capital allocation and stewardship



Source: PRI IN A CHANGING WORLD SIGNATORY CONSULTATION, PRI BOARD RESPONSE, March 2023

The Six Principles (2006)

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with **broader objectives of society**. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1 **We will incorporate ESG issues into investment analysis and decision-making processes.**

2 **We will be active owners and incorporate ESG issues into our ownership policies and practices.**

3 **We will seek appropriate disclosure on ESG issues by the entities in which we invest.**

4 **We will promote acceptance and implementation of the Principles within the investment industry.**

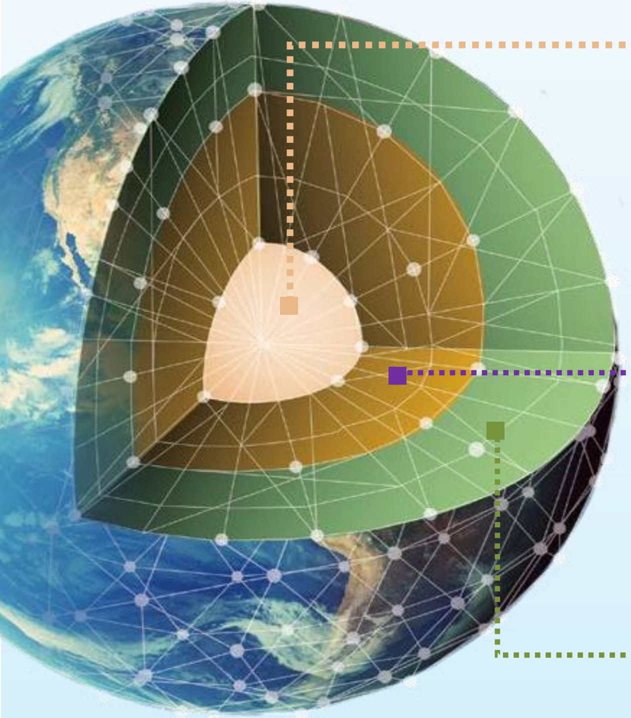
5 **We will work together to enhance our effectiveness in implementing the Principles.**

6 **We will each report on our activities and progress towards implementing the Principles.**

In 2017 the PRI formalized the SDGs' role in framing these societal objectives, committing to "enable real-world impact aligned with the SDGs", and to contribute to "a prosperous world for all".

The Blueprint for Responsible Investment (2017)

The Blueprint is the PRI's mandate for the next decade – with an ambitious agenda for the next 10 years, we plan to tackle some of the most pressing ESG issues in the world today. Through nine priority areas, we will encourage signatories to become more active owners, to inspire leadership and support sustainable investment strategies, resulting in prosperous and inclusive societies for future generations.



RESPONSIBLE INVESTORS

We will strengthen, deepen and expand our core work: to lead responsible investors in their pursuit of long-term value and to enhance alignment across the investment chain.

- EMPOWER ASSET OWNERS
- SUPPORT INVESTORS INCORPORATING ESG ISSUES
- FOSTER A COMMUNITY OF ACTIVE OWNERS
- SHOWCASE LEADERSHIP AND INCREASE ACCOUNTABILITY
- CONVENE AND EDUCATE RESPONSIBLE INVESTORS

SUSTAINABLE MARKETS

We will address unsustainable aspects of the markets that investors operate in, to achieve the economically efficient, sustainable global financial system that responsible investors and beneficiaries need.

- CHALLENGE BARRIERS TO A SUSTAINABLE FINANCIAL SYSTEM
- DRIVE MEANINGFUL DATA THROUGHOUT MARKETS

A PROSPEROUS WORLD FOR ALL

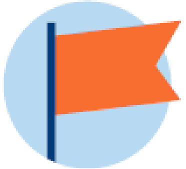
We will enable signatories to improve the real world – now and in the future – by encouraging investments that contribute to prosperous and inclusive societies for current and future generations.

- CHAMPION CLIMATE ACTION
- ENABLE REAL WORLD IMPACT ALIGNED WITH THE SDGs

Active Ownership 2.0 (2019)

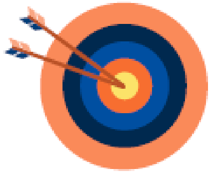
Active Ownership 2.0 is a vision for an evolved standard in stewardship that is underpinned by an increase in investors' ambition and assertiveness. It prioritises critical systemic goals and collective effort aimed at concrete outcomes, rather than processes and activities or narrow interests.

The three central elements to an Active Ownership 2.0 approach are set out below.



OUTCOMES, NOT INPUTS OR PROCESSES

Active ownership 2.0 prioritises the pursuit and achievement of positive real-world goals.



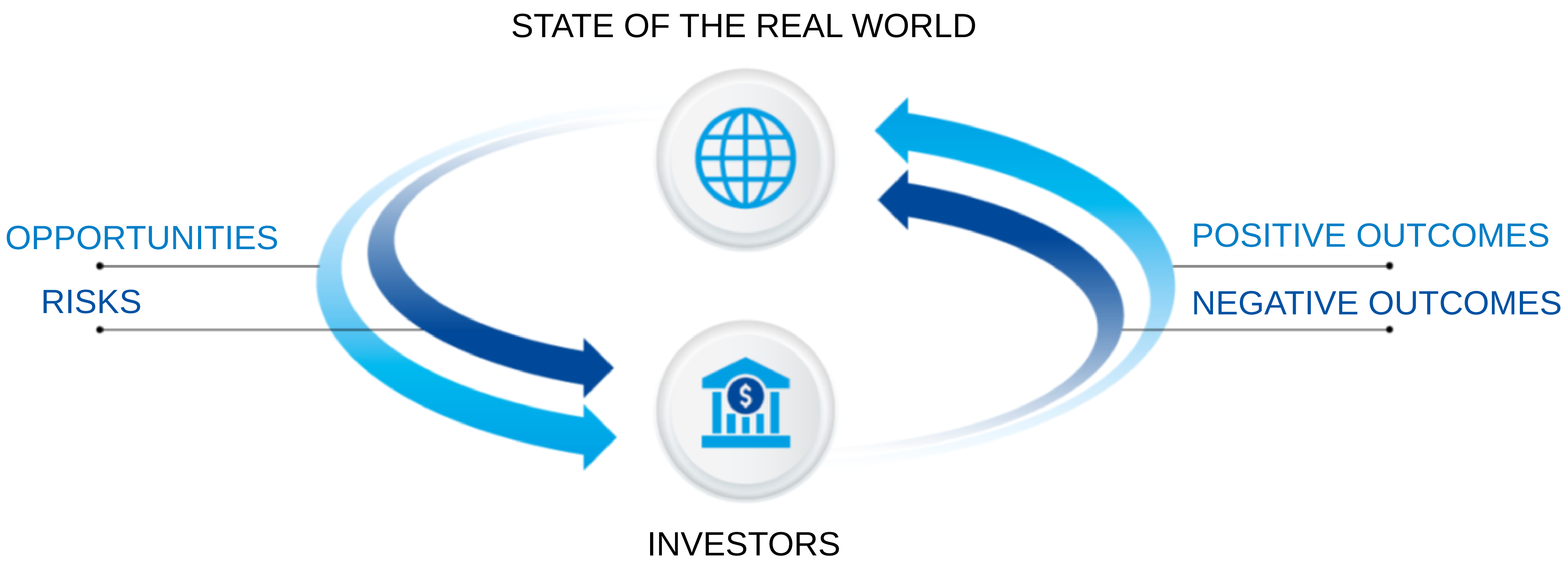
COMMON GOALS

Systemic issues require a deliberate focus on and prioritisation of outcomes at the economy or society-wide scale. This means stewardship that is less focused on the risks and returns of individual holdings, and more on addressing systemic or 'beta' issues such as climate change. It means prioritising the long-term, absolute returns for universal owners, including real-term financial and welfare outcomes for beneficiaries more broadly

COLLABORATIVE ACTION

Focusing on collective goals and the delivery of positive real-world outcomes is possible only through enhanced collaboration among investors and service providers. Challenges inherent in addressing collective systemic issues, such as the free-rider problem, result in weaker pursuit of collective goals. Enhanced collaboration spreads the cost of addressing collective goals and is therefore central to achieving the required evolution in stewardship practice.

Investing with SDG Outcomes (2020)



- There is a continuous feedback cycle between (ESG) risks and opportunities and (SDG-aligned) outcomes: ESG issues create risks and opportunities for investors, whose actions shape outcomes on the world, which feed back into portfolios in the form of ESG risks and opportunities.
- A focus on shaping SDG outcomes involves broadening the analysis of **individual** investees' financially material ESG issues, to also include a parallel analysis of the most important outcomes to society and the environment at **a systemic level**. These material issues and real-world outcomes overlap to some extent, but not fully, and this is part of the gap that needs to close to achieve the SDGs by 2030.

Legal Framework for Impact (2021)

- Investing for Sustainability Impact (IFSI) : investment approach where investors ***intentionally*** **attempt to influence the behavior of investee companies and other third parties in *assessable* ways that can help achieve overarching sustainability outcomes**
  - Broader concept than impact investing
  - Easily applicable to an investor's entire portfolio
  - Can include sustainability laggards in the portfolio

- To engage in IFSI, investors must pay attention to clarity about the outcomes concerned ('goal certainty')
  - overarching sustainability outcomes (e.g. Paris Agreement and SDGs)
  - portfolio-level sustainability impact goals
  - more specific sustainability impact goals (enterprise-by-enterprise targets)

- To a significant extent **the law requires or permits IFSI** although, given the diversity of jurisdictions and investor types covered, there are all sorts of variations.

Progression Pathways Framework: Investor Purpose-based Model (2025)

	PATHWAY A	PATHWAY B	PATHWAY C
	Incorporating ESG factors	Addressing the drivers of sustainability-related financial risks	Pursuing positive impact
Progression	Level 3	Level 3	Level 3
	Level 2	Level 2	Level 2
	Level 1	Level 1	Level 1

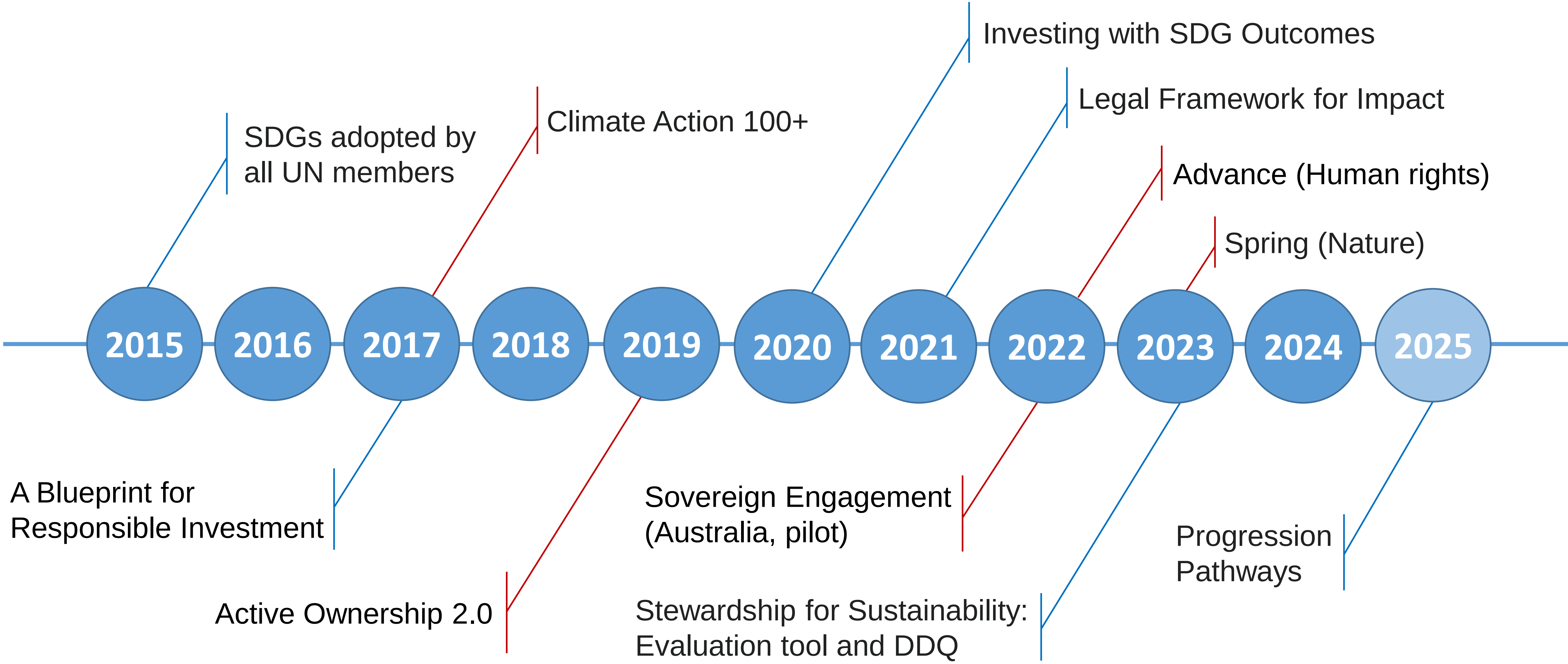
More advanced levels may involve incorporating system-level risks and identifying positive and negative sustainability outcomes.

Leve 3 may involve broader system engagement with other actors.

Level 2 may involve incorporating system-level risks in company stewardship activities.

Level 1 may involve articulating the inclusion of system-level risks in the investment policy.

Addressing System-level Risks: PRI



Field Building

- System-level investors use both conventional and advanced investment techniques as tools to mitigate system-level risks, one of the key tools being field building

- Five tactics for field building that sustainable investors can use to increase their impact

  - Shifting other investors' evaluation of issues
  - Sharing expertise with other investors
  - Delegitimizing business activities that are harmful for the environment and society
  - Establishing voluntary standards
  - Supporting regulatory changes

（Source） Emilio Marti, et. Al., "A more Impactful Strategy for Sustainable Investing", Harvard Business Review, 2023.

Challenges of Field Building

System-level stewardship with tradeoffs

Engaging on system-level sustainability-related risks may require investors to seek changes that are costly for some companies individually but beneficial for the wider economy.

Political exposure

Field building requires that investors publicly take a stance on sustainability issues, which could lead to increased political exposure and backlash by people with different views.

Free rider problem

Some avoid the costs of field building, while reaping the benefits. The result is a weaker pursuit of collective goals than would be the case if the distribution of costs and benefits were more equitable. Thus, despite the importance of field building, investors may not fully engage in it.

Difficult to measure the impacts of system-level strategies

Any risk of “system-level washing”?