Iceland: From strategy to practice

BY RACHEL FIXSEN | NOVEMBER 2019 (MAGAZINE)

Several factors are pushing Icelandic pension funds towards responsible investment

Iceland's fifth largest pension fund, Frjálsi – which outsources its daily operations to Arion Bank – has been focusing on implementing environmental, social and governance (ESG) considerations into investment for the past two years. Arnaldur Loftsson, its managing director, says: "Since 2017, we have been putting great emphasis on building up knowledge and educating stakeholders about what responsible investment practices entail, from strategic implementation to practical approaches."

Icelandic pension funds may be the ESG stragglers in the Nordic pack but a combination of factors is accelerating the development of responsible investment among Icelandic investors. These include recent changes in Icelandic legislation, rising awareness of ESG-related issues among the general public and investors' increasing belief that sustainable factors influence risk-return profiles in the long term.

Frjálsi lífeyrissjóðurinn

- Location: Reykjavik
- Total assets: ISK238bn (€1.73bn)
- Members: 58,629
- Hybrid multi-employer fund
- Data as of end-2018

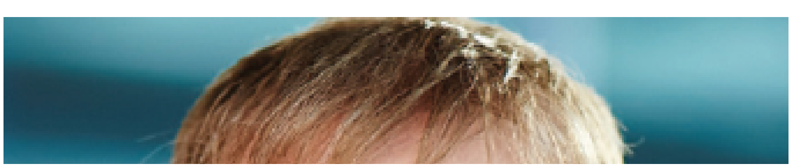
“As a group, we are likely lagging behind our fellow Scandinavians here, as a result of the events of 2008 and the capital controls that followed, after which the main thing was simply to keep a straight line,” says Hjörleifur Waagfjörð, head of Arion Bank’s institutional asset management division.

In July 2017, changes were made to the investment regulation for Icelandic pension funds which included a requirement for the funds to set themselves ethical standards for their investments. More broadly, the investment regulation changes involved stipulations about pension funds’ investment policy statements as well as investment limits, and a shift in emphasis towards fiduciary duty and the prudent-person rule, rather than simply relying on prescriptive investment limits.

The new rule on pension funds setting ethical standards for investments was followed by an explanatory statement that further demarcation would be in the hands of each fund. Most pension funds have responded to the new ethical standards by putting forward a policy on responsible investments.

“We were familiar with the ideology of responsible investment and we had basic knowledge about methodology and different approaches. But we wanted to build on top of that, deepen our knowledge base and be prepared to serve our clients in the best possible way with the inevitable development of responsible investments. A natural starting point was to look at what earlier adapters in the Nordics were doing, who had started taking action on ESG matters in investment before,” Waagfjörð says.

“For this purpose, we visited non-domestic Scandinavian fund management companies, institutional segregated asset managers, as well as Norway’s sovereign wealth fund to find out how they were approaching ESG. We wanted to get an overview of how the methodology was really put into practice in investment processes, and then how it was followed up in investments.



“With that experience forming the backbone of the project, we worked closely with the board of Frjálsi in four months of

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intensive work educating key stakeholders, board members and employees, followed by a sentiment survey, which formed the basis of the policy making regarding responsible investments," he says.

Loftsson adds: "The result was Frjálsi's policy on responsible investments which runs through the entire investment process but with an emphasis on certain focus areas. Mainly due to the capital controls following the financial crises in 2008, Icelandic pension funds have grown relatively large in the domestic listed equity market. Therefore, a starting point was to focus on that asset class. Frjálsi, like many pension funds, has put a special shareholder policy in place, under which the funds address the pressing issue of responsible investment in an attempt to inform the market how they intend to apply their shareholders' rights."

Regulatory push

A year before Icelandic pension funds were required to lay down ethical investment standards for themselves, a crucial piece of transparency regulation had come into force for the island's larger companies, as part of the Annual Financial Statement Act.

Under the new rules, the companies had to include non-financial information in their reports according to certain criteria – although it is left up to them how to do this.

But despite this, data has still been a particular challenge for the Icelandic-based fund in its ESG work.

Waagfjörð says: "The number of international ESG data providers for investors has been growing fast but, so far, no one has set up an ESG data provider for the Icelandic market – and the international ones don't include information on many of the Icelandic companies, so ESG information on the

Icelandic market is scarce.

“So, in practice, an obvious point for us to start was to analyse and meet all the Icelandic Nasdaq-listed companies – one-to-one, at board or executive committee level – and to conduct an analysis of companies’ non-financial information.”

The aim of the analysis was to shed light on how Icelandic listed companies report their non-financial information and then to see whether it is possible to measure their performance here according to the principles of the UN Global Compact.

How Icelandic firms report non-financial data

Among the 16 companies listed on the Nasdaq Iceland main market In 2017, there were considerable differences between how the companies handled their non-financial information reporting. The findings suggested that in general, Icelandic listed companies were well aware of their corporate social responsibility (CSR) but still fell short in their reporting on it.

Six of the companies had chosen an official guide or principal on which to base their non-financial information. Two companies were relying on the Global Reporting initiative (GRI) and four based their reporting on the ESG NasdaqOMX Reporting Guide for Nordic & Baltic Markets. There were no significant differences between the companies based on the reporting method, the analysis showed, suggesting it was more important to choose an official guideline rather than which particular guideline was chosen.

A quick view of annual statements for 2018 published by Iceland’s listed companies shows there is a year-on-year increase in the number of companies choosing an official guideline for their reporting of non-financial information. This suggests, according to Waagfjörð, that more and better ESG data will become available on the Icelandic equity market. over time, giving investors more opportunity to develop their responsible investments further.

Waagfjörð and the team used the Nasdaq Nordic ESG Reporting Guide as a reference in the analysis and, based on this, reviewed all published and accessible material for each of the companies – from websites, annual statements and so on. The next step was to send the findings to the companies themselves, Waagfjörð says. That was alongside a request for a meeting to review the results, thus giving the businesses the chance to express their views and discuss corporate social responsibility (CSR) in general.

"The main issues in the analysis indicate that Icelandic companies are well aware of their social responsibility but that in general their reporting on this is inadequate," Waagfjörð says.

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Hjörleifur Waagfjörð

Six companies listed on the Nasdaq Iceland main market rely on an official principle or guideline in disclosing non-financial information. Other companies, meanwhile, do not disclose their non-financial data in a systematic way, but do disclose additional information in accordance with the principles of the UN Global Compact and other domestic established sets of climate objectives – such as the climate objectives managed by Festa, those set by the Icelandic Centre for Corporate Social Responsibility, and those coined by Reykjavík City.

"It also caught our attention that six of the companies did not disclose any information on the environmental effects of their operations, a matter within ESG that will probably gain growing attention in the near future.

"According to our methodology we found that three companies failed to fulfil any of the 10 principles of UN Global Compact. The majority only fulfilled 20% of the principles and the top performer had a 90% result.

"Overall, the responses from the companies were positive, and there were some good conversations on corporate social responsibility between our representatives and those of the companies," Waagfjörð says.

Continued development

Frjalsi sees its completed ESG project as just the foundation for what will become an important area in further developing its approach to responsible investing, according to Loftsson.

He says: “It’s certain that the emphasis on non-financial information and corporate social responsibility will continue to increase in the near future, and the team will be at the helm, observing and participating in the development of responsible investment amongst Icelandic pension funds.”

The government’s decision two years ago to make Iceland’s pension funds establish ethical investment standards has, he believes, been good for all stakeholders.

Waagfjörð adds: “Companies have come under pressure to publish more than just their conventional financial information, as a result of a heavier emphasis on corporate social responsibility from authorities and regulators on the one side, he says, and on the other – more demand from the public for them to be transparent about corporate practices.

“The changes in the law on financial statements in 2016 then forced the hand of companies of a specific size and of public interest,” he says.

Does Frjálsi believe the ESG work will actually feed through into higher investment returns? Loftsson hopes so but points out that new policies have only just been implemented by Icelandic pension funds. “Hopefully these increased demands regarding investment will lead to more structured governance and social responsibility which will further make its mark in the form of more positive returns in the long run.

“Time will be the best judge, though – but we are positive about the road ahead,” he says.