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Financial Sector Policy Branch
Department of Finance Canada
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Sent by email to: LegislativeReview-ExamenLegislatif@canada.ca

Re: Supporting a strong and growing economy: Positioning Canada's financial sector for the future

We are writing in response to the request for comments on the consultation document for the review of the federal financial sector framework.[1] We consent to the disclosure of this submission, noting that in the interests of transparency we post policy submissions to our own website routinely.[2]

With approximately $6 billion in assets under management, NEI Investments' approach to investing incorporates the thesis that companies integrating best environmental, social and governance (ESG) practices into their strategy and operations will build long-term sustainable value for all stakeholders and provide higher risk-adjusted returns to shareholders. The company evaluations, corporate engagement and research activities that we conduct to fulfill our responsible investment commitments give us insight into Canadian companies' progress in responding to sustainability risks, the obstacles they face, and how appropriate policy could support their efforts. NEI's holdings include equity and fixed income instruments issued by federally-regulated Canadian financial institutions. The soundness of these financial institutions is critical to our business and to the health of the Canadian economy. In addition, a wide range of Government of Canada policies impact or are impacted by the financial sector, and it is important that the financial sector framework should contribute to federal policy coherence.

In the following pages, we discuss a range of issues that we expect to significantly influence or be influenced by the financial sector. Our input can be summarized as follows:

- The review of the financial sector framework should explore ways to further stimulate the growth of responsible investment in Canada.
- Financial institutions are expected to adopt a responsible business conduct. In this regard, the outcomes of OECD's current process to develop specific guidance on due diligence approaches for responsible business conduct in the financial sector should be considered. In addition,

[1] Department of Finance Canada (2016). Supporting a Strong and Growing Economy: Positioning Canada's Financial Sector for the Future. A Consultation Document for the Review of the Federal Financial Sector Framework https://www.fin.gc.ca/activty/consult/ssge-sefc-eng.asp

[2] NEI's submissions on public policy and standards can be found at: https://www.neiinvestments.com/pages/about-nei/about-ethical-funds/esg-difference/public-policy-and-standards/

clarification of the *Prohibiting Cluster Munitions Act* in terms of the scope of the prohibition of investment and an official list of cluster munitions manufacturers the prohibition applies to would also be helpful.

- The critical role of the financial sector in advancing sustainable development should be highlighted.
- The role of the financial sector in the transition to a low-carbon economy should be emphasized.
- Cybersecurity is indeed a key emerging risk for the financial sector.
- The need to maintain the "social license to operate" of the financial sector should be addressed.
- Effective corporate governance is critical to the sound functioning and stability of the financial sector and as a minimum, any corporate governance enhancements to the CBCA should be added to the statutes covering the incorporation of federally-regulated financial institutions

Responses to consultation questions

Question 1. What are your views on the trends and challenges identified in this paper? Are there other trends or challenges that you expect to significantly influence the financial sector going forward?

We would like to draw attention to several trends, challenges and opportunities that were either omitted or not fully addressed in the consultation paper.

Growth of responsible investment

Responsible investment, in which environmental, social and governance (ESG) factors are incorporated into investment practices, is growing significantly both globally and in Canada. Over 1500 investment institutions, representing more than US$60 trillion in assets under management, are signatories to the United Nations-supported Principles for Responsible Investment (PRI), including 86 Canadian financial institutions.[3] This global collaboration aims to advance the practice of responsible investment and support signatories incorporating ESG factors to their investment processes. Further, as of December 31, 2013, Canada's responsible investment market had increased from $600 billion to more than $1 trillion of assets under management within two years, representing 68% growth.[4] 31% of the Canadian investment industry has espoused responsible investment in some form.

We believe this trend presents an opportunity to advance federal economic, social and environmental objectives. The review should explore ways to further stimulate the growth of responsible investment in Canada. In this context we draw attention to our recent submission to the consultation on the Federal Sustainable Development Strategy, in which we discussed a wide range of opportunities and challenges for responsible investment in Canada.[5]

[3] https://www.unpri.org/about
[4] RIA (2015). 2015 Canadian Responsible Investment Trends Report https://riacanada.ca/wp-content/uploads/2015/01/RI_Trends_Report2015_EN.pdf
[5] NEI (2016) Environment and Climate Change Canada: Federal Sustainable Development Strategy 2016-19

Emerging expectations on responsible business conduct of financial institutions

Responsible Business Conduct under the OECD Guidelines

As well as taking into account ESG factors that may impact the value of an investment, there is an emerging expectation that financial institutions should also avoid causing environmental and social harm. Adopted in 1976, the OECD Guidelines for Multinational Enterprises (the Guidelines) are a comprehensive set of recommendations on corporate responsibility backed by over 40 countries, including Canada. The Guidelines cover many aspects of responsible business conduct including employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation. Adhering governments must set up a National Contact Point (NCP) to act as a grievance mechanism in cases where companies are alleged to have breached the Guidelines. The Guidelines were last updated in 2011, taking into account the adoption of the UN Guiding Principles on Business and Human Rights (the UNGPs). According to the UNGPs, all companies have the "responsibility to respect" human rights, and a human rights due diligence approach is promoted. Under the Guidelines, enterprises are encouraged to conduct due diligence to prevent and mitigate adverse impacts that are directly linked to their operations, products or services, including through their supply chain and business relationships. An emerging issue is the question of how this concept applies to investors (including minority shareholders). In the period 2011-2015, 17% of grievance instances raised with NCPs related to the financial sector, compared with only 8% in the period 2000-2010[6].

The OECD has been undertaking a multi-stakeholder process to develop guidance on due diligence approaches for application of the Guidelines in the financial sector.[7] The outcomes of this process should be considered within the financial sector framework review.

Uncertainty regarding prohibition of investment in cluster munitions

During the passage of the *Prohibiting Cluster Munitions Act*, representatives of the government of the time stated on several occasions that direct and intentional investment in a commercial organization that produces cluster munitions would fall under the prohibition against aiding and abetting within the Act.[8]

At NEI, we were not invested in any known cluster munitions manufacturers at the time the legislation was passed. However, as it appeared that the intention of Parliament was to ban Canadian investment in cluster munitions manufacturers, to ensure that we remained compliant with that intention into the future, NEI and several of our partner organizations decided to implement formal policies to exclude cluster munitions manufacturers across our portfolios.[9] We felt that a prohibition on "direct and intentional investment in a commercial organization that produces cluster munitions" was relevant for our active management investment approach. Our responsible investment team drew up and maintains a list of known cluster manufacturers, and we issued instructions to all subadvisors not to purchase the

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[6] OECD (2015). Implementing the OECD Guidelines for Multinational Enterprises: the National Contact Points from 2000 to 2015. https://mneguidelines.oecd.org/15-Years-of-the-National-Contact-Points-Highlights.pdf

[7] We submitted comments on a discussion paper circulated as part of this process. NEI (2016) Organization for Economic Cooperation and Development (OECD): Responsible Business Conduct for institutional investors

[8] For example, during the Senate introduction of Bill C-6: http://www.parl.gc.ca/Content/Sen/Chamber/412/Debates/077db_2014-09-18-e.htm?Language=E#27

[9] NEI's policy can be found at this link: http://www.neiinvestments.com/documents/PublicPolicyAndStandards/2015/NEI%20Cluster%20Munitions%20Policy.pdf

securities of these companies. It is less clear to us whether any prohibition might apply to other financial relationships, such as passive investment in an index that happens to include a cluster munitions manufacturer. Furthermore, as far as we are aware, no official list of cluster munitions manufacturers that should be avoided for investment in order to comply with the Act has been published. We note that several other countries that have legislated cluster munitions prohibitions have provided details on the investment prohibition, either within legislation or through interpretive guidance.[10]

We believe it would be helpful to the Canadian investment community for the Federal government to clarify the scope of the prohibition on investment under the Act, and which weapons companies the prohibition applies to. We encourage the Federal government to undertake further specific consultation with the investment community on this topic. As an investment institution currently operating a cluster munitions exclusion policy, we would be glad to participate in such a process.

The role of the financial sector in sustainable development

The consultation paper does not explore the potential for the financial sector to contribute positively to federal social and environmental objectives, as well as economic objectives. This potential was highlighted in the recently-published Federal Sustainable Development Strategy 2016-2019, which recognizes that "a strong economy and a clean environment must go hand in hand in the modern world." In addition, investors are identified as one of the key partners in sustainable development "by taking environmental, social and governance factors into account in investment decisions and by engaging with companies to encourage sustainable practices".[11] In this context we would also highlight emerging discussion of the role of finance in the achievement of the United Nations Sustainable Development Goals[12].

The role of the financial sector in the transition to a low-carbon economy

Climate and environmental change are rightly presented as factors increasing the potential for losses from catastrophic events (p28), and as a specific risk for property and casualty insurers (p14). Climate change is widely accepted in economic circles as a key global threat.[13] However, the challenge to financial sector stability extends beyond catastrophic risk to encompass the risks and opportunities for the financial sector in navigating the transition to a low-carbon economy.

The Financial Stability Board (FSB) has launched a Task Force on Climate-related Financial Disclosures to develop guidelines for consistent climate-related financial risk disclosures by companies for use by investors, lenders, insurers and other stakeholders, and contribute to understanding of the financial sector's exposure to climate-related risk, both at the level of the individual firm and at a systemic level.[14] We urge that the Task Force's final recommendations, expected in late 2016, should be taken

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[10] An overview of legislation globally by one of the civil society organizations can be found here: http://www.stopexplosiveinvestments.org/legislation

[11] Government of Canada (2016). Achieving a sustainable future. A federal sustainable development strategy for Canada 2016-2019. https://www.ec.gc.ca/dd-sd/CD30F295-F19D-4FF9-8E03-EAE8965BE446/3130_FSDS_Eng_FINAL.pdf

[12] For example: Dialogues at the PRI level involving global stock exchanges, institutional investors and policy makers on the role of private sector in UNSDGs https://www.unpri.org/press-releases/exchanges-policymakers-and-investors-share-views-on-supporting-the-united-nations-sustainable-development-goals

[13] For example: World Economic Forum (2016). 2016 Global Risk Report. http://www3.weforum.org/docs/Media/TheGlobalRisksReport2016.pdf

[14] FSB. Task force on climate-related financial disclosures https://www.fsb-tcfd.org/

into account in the review of the financial sector framework.

We note in this context that the Office of the Superintendent of Financial Institutions (OSFI) has already questioned the extent to which Canada's major banks are prepared to absorb credit losses from fossil-fuel loans, such as oil and gas lending, especially in the context of collapsing of commodity prices and credit downgrades in the energy sector.[15] We believe that Canadian banks should be expected to have a robust credit assessment process with regard to their fossil fuel exposure, and provide disclosure to investors, enabling this exposure to be better understood.

Further consideration should also be given in the review to ways in which the financial sector policy framework can better support innovation and clean technologies that take advantage of opportunities presented by the transition to a low-carbon economy, in line with the government's vision of a "Clean Growth Economy."[16] For example, this may include supporting innovative climate financing mechanisms from commercial financial institutions. We note the growing market (and support) for green bonds and climate bonds, both within Canada and globally[17]. We believe green bonds can play a growing role in stimulating the energy transition and encourage the Government of Canada to explore deeper involvement in this area. In 2014 Ontario issued the first provincial green bond, which was strongly embraced by investors, being more than four times oversubscribed. However, retail investors had limited access to this offering, consistent with the global experience for green and climate bonds. The secondary market for green bonds is decidedly shallow. Despite the rapid growth of the green and climate bond market, it is still relatively difficult for investors to get exposure to this asset class. The Federal Government has a role to play in both increasing the access to high quality green bonds and in ensuring that standards around green bond issuance are credible, robust and transparent. In this context, we would highlight that investors representing US$2.2 trillion in AUM have signed the *Green Bonds Statement*[18] calling on governments to support issuance of bonds that address climate change based on clear standards.

Cybersecurity

We agree that cybersecurity is a key emerging risk for the sector. As we shared in our recent submission to the federal consultation on this topic[19], from an investor perspective the economic and social significance of cyber security is clear: data breaches represent a material financial risk that can negatively affect company value, in addition to representing a social risk that can negatively affect a company's reputation and the privacy and security of customers and other stakeholders.

We would like to take this opportunity to bring to your attention an international investor initiative on this topic. As a signatory to the UN PRI, we are participating in the recently-established PRI Advisory Committee on Cyber Security, tasked with enhancing signatories' understanding of investment risks and opportunities associated with cyber security and developing a strategy for engaging the corporations within our holdings on this topic. Areas of focus include: cyber security developments;

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[15] Trichur Rita 2016. "Regulator urges Canadian banks to review oil and gas reserves". The Wall Street Journal, March 21. http://www.wsj.com/articles/regulator-urges-canadian-banks-to-review-oil-and-gas-reserves-1458576613

[16] Government of Canada (2016). Chapter 4 - A Clean Growth Economy http://www.budget.gc.ca/2016/docs/plan/ch4-en.html

[17] Investor Statement re: Green Bonds & Climate Bonds (2014). https://www.neiinvestments.com/documents/PublicPolicyAndStandards/2014/Investor%20Statement%20on%20Green%20Bonds%20and%20Climate%20Bonds%2020141211.pdf

[18] The Paris Green Bonds Statement (2015). http://www.climatebonds.net/files/files/Paris_Investor_Statement_9Dec15.pdf

[19] NEI (2016). Public Security Canada: Consultation on Cyber Security

which sectors and what types of data are most at risk; corporate awareness, preparedness and post-breach management; board-level cyber governance; corporate disclosure; due diligence; and regulatory developments. As outputs from the work of the Advisory Committee become available, we will be glad to share them.

Social license to operate of the financial sector

The consultation paper does not address the need to maintain the "social license to operate" of the financial sector. Concerns about the utility to wider society of some activities by financial institutions, and about the role of the sector in exacerbating income inequality, have contributed to social discontent and political instability, notably in the United Kingdom and the United States.

Global financial institutions, including Canadian banks, have been criticized for excessive executive compensation. Based on fifty years of data across member countries, the OECD found that financial expansion fueled greater income inequality, mainly because of credit overexpansion benefiting a wealthier demographic, and high pay in the financial industry.[20] We support OECD's recommendation that to ensure a healthy contribution of the financial sector to strong and equitable growth, and for the sake of stability, financial sector reforms should aim at improving the contribution of finance to economic and social well-being - boosting economic growth while reducing income inequality. The review should therefore consider the extent to which any reforms to the financial sector framework enhance the stability, efficiency and utility of the financial sector when viewed from the perspective of other societal stakeholders (businesses, individuals and families).

Question 5. What other actions should be taken to ensure the financial sector framework remains modern and technically sound?

We believe that effective corporate governance is critical to the sound functioning and stability of the financial sector. Experience has shown that corporate governance failures can have disastrous impacts on financial institutions and markets. In particular, the Financial Stability Board has acknowledged the importance of corporate governance by designating the OECD Principles of Corporate Governance as one of its key standards for sound financial systems.

The federal government has recently proposed amendments to Canada Business Corporations Act to improve corporate governance practices.[21] We urge that as a minimum any corporate governance enhancements to the CBCA should be added to the statutes covering the incorporation of federally-regulated financial institutions.[22]

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[20] OECD (2015), "How to restore a healthy financial sector that supports long-lasting, inclusive growth?", OECD Economics Department Policy Notes, No. 27, June 2015. http://www.oecd.org/eco/How-to-restore-a-healthy-financial-sector-that-supports-long-lasting-inclusive-growth.pdf

[21] Bill C-25 (2016). An act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act and the Competition Act.

[22] We provided a wide range of recommendations on corporate governance enhancements in our submission to the earlier consultation on reform of the CBCA. https://www.neiinvestments.com/pages/about-nei/about-ethical-funds/esg-difference/public-policy-and-standards/

Conclusion

We appreciate the opportunity to offer our perspective on the financial sector framework review, and encourage continuing outreach to the responsible investment community and its networks, including Responsible Investment Association of Canada, the Canadian Coalition for Good Governance and PRI Canada Network. Please do not hesitate to contact me if you have any questions in relation to this submission.

Sincerely,
NEI Investments

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cc:
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