RESPONSIBLE INVESTMENTS

Approved by the Board of Directors 14 June 2016

1. Introduction

1.1. Foreword

The State Pension Fund (VER) invests in a wide variety of economic activities across the global market. However, international business involves a number of aspects that are regarded with varying degrees of approval.

Over the past few years, issues related to the environment, social responsibility and governance (ESG[1]) have increased in importance among institutional investors, including pension funds. At the same time, the priorities in the ESG context have also changed. Moreover, the approaches adopted by investors to ESG issues vary a great deal.

This document outlines the principles of responsible investments applied by VER. Responsibility for more detailed guidelines based on these principles rests with the Management Team, while practical implementation is carried out by VER's operational organisation. Performance in applying the guidelines is reported to the Board of Directors as explained below.

1.2. Regulations concerning the investment of pension funds under VER's management

Under the law, VER is required to ensure that the investments it makes are secure, profitable, easily convertible into cash and sufficiently diversified. However, neither the law nor the directive issued by the Ministry of Finance sets out any specific requirements or provides any definitions for responsible investments. Yet it is clear that VER is not to promote any unsustainable, irresponsible or improper practices in its economic activities.

Compliance with the principles of responsible investments may not contradict with the requirements concerning VER's investment activities as defined by law. Usually, no such conflict exists because any actions by portfolio companies in violation of applicable ESG policies normally increases the overall risk that the investment is exposed to. Today, ESG issues are perceived as a positive element contributing to companies' value creation. However, it is advisable to consider the possibility that the efforts to seek maximum return may conflict with ESG requirements.

Fundamentally, responsible investments mean due assessment and consideration of the risks related to the environment, social responsibility and governance (ESG) when investments are made and monitored.

1.3. ESG in the international context

VER signed the United Nations Principles for Responsible Investment (UNPRI) in 2011. Once a year, the PRI signatories report on their performance in applying the principles, which will subsequently be rated relative to their peers accompanied by feedback.

[1] Environment, social, governance.

Over the past few years, pension investors across the world have become increasingly sensitive to climate issues. In 2015, a group of institutional investors signed the Montreal Carbon Pledge on reporting the carbon footprint of their investment portfolios and the Paris Pledge designed to mitigate global warming. Following the adoption of the Paris climate agreement, France has passed laws obligating companies and investors to disclose their climate and ESG risks. VER has not signed these commitments as yet.

2. Key themes of responsible investments by VER

2.1. ESG in VER's investment activities

Environmental and social responsibility and good governance are evolving concepts open to interpretation. From VER's point of view, the key points are as follows:

Environmental responsibility involves a number of elements. Traditionally, environmental responsibility is understood in terms of protecting the immediate environment from pollution and decay. More recently, the focus has shifted to issues related to climate change and, in particular, the carbon footprint. Over the past few years, measurement of the carbon footprint and awareness, reporting and efforts to reduce it have been adopted as a standard by pension funds, something that VER also needs to do.

Social responsibility implies a specific obligation to respect and comply with international conventions. For VER, this means the UN Global Compact principles[2] and related international regulations concerning human rights, labour rights, environment and anti-corruption. Additionally, VER seeks to refrain from investing in industries that may involve questionable aspects in terms of social responsibility, such as weapons, alcohol, tobacco, illegal substances, gambling and adult entertainment.

Governance calls for transparency and a rational and sustainable organising of activities. For companies that VER invests in, this means, amongst others, compliance with sound corporate governance principles and respect for the rule of law, not only in environmental and social issues, but also in financial contexts such as corporate law, competition law and taxation. VER does not approve of illegal activities. Even activities that are compliance with the law may contradict with the requirements imposed by VER for good governance, if the activities clearly conflict with the purpose of the relevant regulations, for example in the field of corporate law or taxation.

2.2. VER's ESG criteria

In its investment activities, VER focuses on ESG criteria that are consistent with its investment objectives and in respect of which VER is in a position to implement and monitor the criteria, given the resources available. Key criteria:

1. Respect for the PRI and encourage sustainability;
2. Respect for universal international standards and norms;
3. Transparency of ESG issuulanvares in all asset classes.

[2] The Universal Declaration of Human Rights, The International Labour Organisation's Declaration of Fundamental Principles and Rights at Work, The Rio Declaration of Environment and Development and The United Nations Convention Against Corruption.

3. Implementation of responsible investments

The methods used in implementing responsible investmens may vary in terms of the adopted approach because there is no universally applicable definition of ESG in the investment industry; instead, each player perceives it differently placing the emphasis on different priorities. The methods used by VER to pursue responsible investments are governed by the following considerations with due allowance for the asset class involved:

1. Integration of ESG issues in the decision-making process;
2. Direct monitoring of ESG performance – active ownership;
3. Indirect monitoring of ESG performance – passive ownership;
4. Active participation in shareholder meetings;
5. Engagement;
6. Norm-based screening;
7. Divestments.

3.1. Listed equity and fixed income investments

VER is best placed to engage with the companies as a shareholder. For corporate bonds, the opportunities for engagement differ from those offered by listed equities. ESG criteria cannot directly be applied to government bonds, meaning that they are not assessed in terms of responsibility.

Portfolio managers consider ESG issues as part of the overall analysis of the prospective investment before making the decision. As a major investor, VER strives to engage in its investees through active dialogue.

With listed investments in equities and bonds, VER expects the companies to have in place an ESG policy and comply with the international standards based on the UN Global Compact principles. VER monitors the carbon footprint of the companies in its portfolio and seeks to reduce its footprint in the future. This can be accomplished by selecting ‘the best in the industry’ companies in the portfolio or reducing the weight of industries generating large carbon dioxide emissions.

VER’s representatives attend the shareholder meetings of the key listed Finnish companies in its portfolio and exercise voting rights on VER’s behalf. VER’s representatives serving on the boards of non-listed companies are best placed to have a say in corporate affairs, including ESG issues.

VER’s portfolio managers monitor and discuss ESG issues at meetings with the portfolio companies even after the investment is made. If the company fails to meet the ESG standards applied by VER or if its performance raises questions, VER initiates talks with the company or takes other action to influence its behaviour. The primary objective is to improve ESG performance, normally a better alternative than exit, both in terms of promoting responsible action and earning a better return on the investment.

The last resort is to exit from the ownership if the company fails to meet VER’s ESG criteria.

3.2. Investments in actively managed funds

In VER investments in actively managed funds include alternative investments in private equity, real estate, infrastructure and private credit funds, active investments in fixed-income and equity funds as well as hedge and risk premium funds.

Portfolio managers consider ESG issues as part of the overall analysis of the prospective investment before making the decision. In certain cases, the most opportune time for influencing the investment manager's and fund's principles of operation is when the investment decision is made.

VER expects the portfolio funds to commit to ESG principles, integrate these issues in its investment decisions and report on its ESG performance to investors. VER prefers funds in which the asset manager has signed the PRI – or is otherwise, on the strength of the evidence provided, deemed to act responsibly – and is thus committed to monitoring the portfolio companies' compliance with the Global Compact platform. Many asset managers provide ESG reports voluntarily already when marketing their products, and often the information disclosed meets VER's ESG requirements.

VER invests exclusively in funds whose management company is located in a jurisdiction that is committed to acceding to the OECD's Automatic Exchange of Information (AEOI) convention no later than 2018. The United States is deemed as one of these jurisdictions as it has signed bilateral tax agreements pursuant to the Foreign Account Tax Compliance Act (FATCA).

ESG issues are discussed at meetings between VER's portfolio managers and asset managers also after the investment is made. If any of the companies in the fund's portfolio fails to meet the ESG standards applied by VER or if its ESG performance raises questions, VER initiates talks with the asset manager or takes other action to influence the fund's operations. VER may also divest if its investees fail to satisfy VER's ESG standards. However, divestments from private equity, real estate, infrastructure and private credit funds are not usually possible.

3.3. Investments in passively managed funds

VER's investments in passively managed funds are index funds and ETFs. With these investments, ESG integration is assessed in the decision making process. Responsibility is verified through passive monitoring because investments in index and exchange-traded funds are based on a given index, without any consideration of the individual assets to be included in the portfolio. VER can divest these investments quickly if preferred.

4. Integration and reporting

The principles of responsible investments principally apply to VER's entire investment portfolio. As described, the opportunities for monitoring and engaging with the investee companies vary according to asset class and may be relatively limited particularly in the case of indirect investments.

VER's portfolio managers document the ESG issues related to investment decisions and monitoring in accordance with standing instructions.[3] VER's direct investments are screened annually by an independent party with regard to norm violations and production of controversial weapons.[4]

VER co-operates with a third-party to calculate the carbon footprint of its direct equity portfolio.

VER reports to the UN PRI on an annual basis.

VER's ESG performance, carbon footprint and integration of the RI policy are reported to the Board of Directors annually.

The fundamental policies outlined in this document may only be revised by the decision of VER's Board of Directors. VER's Management Team issues guidelines and seeks to develop the procedures to promote the implementation of the principles of responsible investments.

[3]More detailed guidelines are issued by VER's Management Team.
[4] Global Compact and Ottawa Landmine Convention.