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Current Trends in Pension Investment, including Ethical Investing

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Current Trends in Pension Investment including Ethical Investing: Canada

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Canadian Pension Plans – Investment Trends

- Growth of Responsible Investment (RI) and use of Environmental, Social and Governance (ESG) factors
    - "ethical" investing?
    - will focus on ESG
- Canadian legal and regulatory landscape
- Defined contribution issues

Canadian Pension Investment Trends – By the numbers

- Growth of RI in Canada
- 2015 Canadian Responsible Investment Trends Report:

  increasing number of large Canadian pension funds adopting RI policies and procedures: $600 Billion in 2011 to $1 Trillion incorporating ESG in 2013
- RI market now accounts for 31% of Canadian investment industry;
- $820 Billion assets under management in RI driven by pensions

Canadian Legal Environment – Legislation and Regulatory Policy

- Canadian pension legislation contains broad investment requirements, but limited references to ESG
- Ontario is first Canadian jurisdiction to mandate ESG disclosure
  - Differing views on the benefits and necessity of such an approach

Canadian Legal Environment – Legislation and Regulatory Policy

- No Canadian case law
- UK and US cases expected to be persuasive
  - *Board of Trustees v. City of Baltimore*
  - *Harries v. Church Commissioners for England*
  - *Cowan v. Scargill*
  - *Martin v. City of Edinburgh*

Canadian Legal Environment – Legislation and Regulatory Policy

- British Columbia *Pension Benefits Standards Act* and Alberta *Employment Pension Plans Act:*

  Pension plan investments "must be made…in the best financial interests of plan members and other persons entitled to benefits under the plan…"

  - Does NOT
    - Change case law, or
    - Preclude consideration of ESG factors

Canadian Legal Environment – Legislation and Regulatory Policy

- Manitoba *Pension Benefits Act*

  Non-financial criteria (e.g., ESG) can be considered <u>if</u>:

  - The administrator…exercises the care, diligence and skill …that a person of ordinary prudence would exercise in dealing with the property of another person; AND
  - The administrator…invests …in accordance with the regulations and in a manner that a reasonable and prudent person would apply in investing and managing a portfolio of investments of a pension fund

Canadian Legal Environment – Legislation and Regulatory Policy

- Regulations under Ontario *Pensions Benefits Act* now requires that SIPP must include information as to whether ESG factors are incorporated into the plan's investment policies and procedures and, if so, how the factors are incorporated
  - SIPP must be filed with regulator

- Related regulatory policy (FSCO Investment Guidance Note IGH-004):
  - Describes two approaches to ESG factors
    - Financial performance
    - Moral or ethical
  - Directs caution on the 2nd approach
    - Fiduciary duty requires administrator to act in best (financial) interest of the members
    - Moral or ethical concerns cannot trump the fiduciary duty

Canada - Application of Legal Principles

When ESG factors must be considered

- If ESG factors and relevant considerations can help predict financial performance of the entities being considered for investment
- If plan's governing documents so require and doing so does not override the administrator's other common law or legislated duties

Canada - Application of Legal Principles

When ESG factors may be considered

- If investment returns will be maintained or improved
- If the investment decision would, at most, risk a not significant diminution in return
- If an investment contrary to the "very objects" of, for example, a charitable trust

Defined Contribution Pension Plans

- Unique issues for member-directed DC plans
- Some Canadian provinces exempt member-directed DC plans from SIPP requirements
  - Not e.g., Ontario, so ESG disclosure requirements apply
- In practice, administrators of DC plans with member choice may simply defer mandated ESG questions to services providers such as insurers
- Questions about ability to offer “ethical” investment options to members (e.g., “fossil fuel producer free”)
  - Disclosure concerns

Canada – Summary

- Legal certainty – or uncertainty?
- Contrasting approaches to ESG in Canada
- Will regulations in this area benefit pension plan administrators? Plan members?
  - Can they be easily applied in practice?

Current Trends in Pension Investment, including Ethical Investing: South African Pension

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South African Pension Fund Landscape

- Pension funds governed by Pension Funds Act, except for pension funds with their own legislation (Government Employees Pension Fund and large parastatels, which are DB funds).
- In the 1990's big movement of large pension funds from DB to DC, mostly on pressure from trade unions and employers seeking to remove contingent liability from balance sheets.
- Smaller pension funds, at least from 1990's onwards, usually in the form of DC insurance products which although the investments were on an institutional basis, ceased to be viable because of higher governance and compliance costs.
- Smaller pension funds began migration to DC multi-employer funds sponsored by insurers and large benefit administrators. Migration encouraged by Regulator to reduce number of funds to be supervised.
- In 2005 there 13735 registered funds, of which 7684 were active; in 2006, 4384 funds were active.

South African Pension Fund Landscape (cont)

- Currently -
  - If pension fund is DB, closed to new entrants, and seeking to transfer pensioner liability to insurer;
  - Only about 2,000 active funds;
  - Largest pension funds are –
    - multi-employer;
    - DC;
    - usually with member investment choice.
- Result is significant move from institutional management of pension fund assets to retail management. Estimated that retail assets are 3 x institutional assets.
- Consequence is higher costs, more choice in the hands of members.

South African Pension Fund Landscape (cont)

- Pension fund policy now directed at –
  - Reducing costs;
  - Emphasis on appropriate defaults –
    - Member investment choice;
    - Exit from fund (preservation);
    - On retirement.
- Challenge is to find ways to incorporate ESG and responsible investing (RI) in this environment.
- Significant thought has been directed to ESG and RI, and large DB funds have developed policies around these.

Relevant Developments

- Code for Responsible Investing in South African (CRISA). Developed in 2011, following UN Principles for Responsible Investing.

- CRISA has 5 principles –

    - Incorporate sustainability considerations including ESG;
    - Demonstrate active ownership responsibilities;
    - Promote CRISA principles;
    - Manage conflicts of interest;
    - Transparency around policies.

- No guidance around how to apply this to the retail market.

Regulation 28 Preamble

"A fund has a fiduciary duty to act in the best interest of its members whose benefits depend on the resopnsible management of fund assets. This duty supports the adoption of a responsible investment approach to deploying capital into markets that will earn adequate risk adjusted returns suitable for the fund's specific member profile, liquidity needs and liabilities. Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character. This concept applies across all assets and categories of assets and should promote the interests of a fund in a stable and transparent environment."

How can ESG factors and RI be made applicable to DC Funds?

- Currently working group established to draft legislation to require ESG factors and RI in respect of pension funds.
- For DC funds with member investment choice the thinking is to –
  - Make it a requirement that each fund;
    - Its application of ESG factors and RI, at least in default arrangements incorporates in its investment policy statement;
    - Reports in its financial statements its activity in this application; and
    - Shows evidence of this.
  - Require each asset manager to develop a house view of ESG factors and RI, and to require reporting in respect of pooled assets per above.

Current Trends in Pension Investment including Ethical Investing: A U.S. Perspective

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US Plan Fiduciaries and ESG Factors

- Has DC plan investment selection based on Environment, Social and Governance Factors caught on in the US?

- The legal environment & regulation
  - ERISA Plans
  - Non-ERISA Plans

- What's Next & Current Concerns

ESG Investment in the US: By the Numbers

- Institutional assets in environmental, social and governance strategies in the U.S. reached $4.04 trillion in early 2014; public pension funds and non-corporate institutional asset owners accounted for $2.7 trillion

- A 2015 survey shows that 27% of public pension plans, 15% of corporate retirement funds have adopted ESG strategies

- The same survey showed that in the corporate retirement context, ESG was adopted in DC plans more often than in DB plans.

  - Statistics from Pensions & Investments, April 4, 2016; US SIF – The Forum for Sustainable and Responsible Investment, Washington, D.C. (2014); Callan Associates Survey (2015)

ESG Factors: Wave of the Future?

- Historical context:
  - Board of Trustees vs. City of Baltimore (Maryland, 1987) at the state level
  - At the Federal level, U.S. Department of Labor, Interpretive Bulletins 94-1 and 2008-01

- Now:
  - U.S. Department of Labor, Interpretive Bulletin 2015-01
  - Activities of state retirement systems: California, New York, North Carolina, Wisconsin
  - Application of ESG factors by fund managers

Legal Framework:
ERISA Plans vs. Non-ERISA Plans

- ERISA
  - Private-sector employers; plan oversight by committees of fiduciaries
  - Regulations issued by U.S. Department of Labor
  - Governs both DB and DC plans; prevalence of DC plans
  - Notable carve-outs: Government plans & Church plans

- Non-ERISA Plans
  - Significant number of plans of States and local governments
  - Regulation often by state/local statute; boards of regulators/investment committees
  - Still significant number of DB plans

ERISA Fiduciaries & ESG – Do Statutory Duties & ESG Align?

- A Fiduciary (ERISA 3(31))
  - Exercises discretionary authority or discretionary control over the management of the plan or disposition of plan assets
  - Renders investment advice for a fee
  - Has discretionary authority or discretionary responsibility in the administration of the plan
  - Investment managers are ERISA fiduciaries (ERISA 3(38))
- Duty of Loyalty
  - Act solely in the interest of participants and beneficiaries for the exclusive purpose of providing benefits and defraying reasonable expenses
- Duty of Care
  - With the care, skill, prudence and diligence of a prudent man acting in like capacity
- Duty to Diversify
  - Diversify investments to minimize the risk of large losses, unless imprudent

ERISA Fiduciaries & ESG: Regulatory Guidance, A Tale of Two (or Three) DOL Bulletins

- No direct regulations regarding ESG under ERISA by the U.S. Department of Labor (DOL); however three interpretive bulletins (IBs):
  - IB 94-01
    - "Everything being equal" test
  - IB 08-01
    - "Everything being equal" + analysis
    - Consider economic benefits beyond returns in "very limited circumstances"
  - IB 15-01
    - Back to "everything being equal" and
    - Preamble suggests that ESG can be a proactive concern of fiduciaries; incorporated into investment policy statements

ERISA Fiduciaries & ESG: DC or DB, or Does it Matter?

- ERISA Fiduciaries for a DB Plan have overall investment authority

- ERISA Fiduciaries for a DC Plan:
  - In non-individual account plans, have similar authority to DB
  - In individual account plans (ERISA 404(c) plans), have the responsibility to choose funds options; have duty to monitor
  - ERISA 404(c) plans with brokerage windows

Non-ERISA Plans & ESG: What the State Funds are Doing

- States concerned with ESG before it was “cool”?
  - Board of Trustees vs. City of Baltimore (Maryland, 1987)

- Large state-retirement funds:
  - Largely DB
    - Pressures on returns/plan funding?
  - Comparison with ERISA fiduciaries?
    - Huge amount of assets under management (comparable only to the very largest U.S. employers)
    - Active in a way that ERISA corporate fiduciaries typically are not

Non-ERISA Plans – CalPERS, A Case Study

- History of applying ESG factors; stated goals & 2014 report
  - E: Carbon Asset Risk, Renewable Resources
  - S: Board oversight, Say on Pay
  - G: Financial Market Reform, Voting Proxies, Foreign Affairs

- 2016 vote on new ESG plan (August); review of existing investment teams and external managers

What's Next for ESG in an ERISA context?

- Fiduciary Focus: ESG appears to be gaining momentum; however, ERISA fiduciaries have other concerns:
  - Litigation: Fees, fees, fees.
  - Regulation: Recent DOL "Conflict of Interest" rule.

- Prudent man principle: How to track ESG in US ERISA DC plans?
  - Revisions to investment policy statements?
  - Increased fund options for DC plans?
  - Participant activity in brokerage windows?

- QUESTIONS?