INVESTMENT GOVERNANCE & ESG INTEGRATION

UPDATE

OECD Workshop on Financing Green Infrastructure
3 November 2016

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BETTER POLICIES FOR BETTER LIVES

Background to the project

- Request by the French Presidency of the COP21 to examine
  - Governance of institutional investments with respect to ESG factors
  - and especially those related to climate change

- Approved by WPPP
  - Progress report June 2016 (also forms part of OECD contribution to G20 GFSG)
  - Final report December 2016

Objectives

1. International stock-take of regulatory frameworks
   - What do they say about ESG integration
   - How is this interpreted by institutional investors

2. Improve our understanding of
   - Policy and business frameworks and ESG
   - Institutional investors' duties and ESG
   - Practical implementation of ESG strategies

Research process

- Interviews with institutional investors
  - How do they understand their duty to beneficiaries
  - How do they integrate ESG factors in practice
- Surveys of regulators
  - Implicit or explicit reference to ESG
  - Complementary measures
- Desk research focusing on
  - Evidence of portfolio impact of ESG factors
  - Evolving interpretations of investors' obligations

Key findings

- Regulation: lack of clarity
  - Regulations permit but (generally) don’t encourage ESG integration
  - Different interpretations of investors’ duties co-exist

- Practical and behavioural obstacles
  - Reconciling ESG integration with accepted practice
  - Understanding the impact of ESG risks
  - Implementing an ESG strategy
  - Competing priorities

Regulatory frameworks

- Prudential standards are open to interpretation

Prudential standard	"Traditional investor"	"ESG investor"
Investing prudently	Markets efficiently price risks including ESG risks where relevant. Use standard measures of portfolio performance, e.g. returns relative to a market benchmark, variance.	ESG factors are not reflected in market prices or usual analytical models. ESG factors provide insight beyond financial filings.
Acting in the best/sole interests of beneficiaries	Portfolios should be managed to generate financial returns for current beneficiaries.	Short-term cash generation can harm long term viability and so future benefit stream. Beneficiaries may consider non-cash benefits.
Taking a long-term view	Assets should be managed in such a way as to meet liabilities.	Consider potential risks beyond the horizon of a typical investment strategy (most institutional investment contracts are awarded for a period of three to five years and most sell-side research projections cover a similar period)
Avoiding conflicts of interest	Beneficiaries' financial interests come first. Other motivations must be secondary to financial returns.	ESG factors are financially relevant but definition of "interests" may be broader.
Diversifying the portfolio	Portfolio diversification is fundamental to risk control under current modelling techniques. Therefore excluding a section of the market from the potential investment universe for reasons that are not purely financial – for example divesting from coal stocks on environmental grounds – could be interpreted as being in breach of prudential standards	Divestment may cause some financial losses – tobacco stocks have demonstrated strong dividend flows and low volatility – but these can be offset to a sufficient extent that beneficiaries' financial interests are protected.

Clarifications

- US – ERISA interpretive bulletin
- UK – DC code
- South Africa – Pension Funds Act
- IORP II

Other regulation

- Other regulation/voluntary codes often supportive
  - Reporting, disclosure
  - Stewardship codes
- But may be conflicting
  - e.g. Pensions: triennial valuations, de-risking

Disclosure requirements

	Pension funds	Insurance companies	Asset Managers
Albania	No	No	No
Australia	Yes	Yes	Yes
Austria	Yes – to regulator; to members upon request	No	
Belgium	Yes – social transparency report		
Canada	No, except Ontario where required for local pension funds. In Alberta, voluntary codes encourage disclosure	No	
Chile	No	No	No
Denmark	Yes – if a responsible investment policy exists	Yes – if a responsible investment policy exists	Yes – if a responsible investment policy exists
Dominican Republic	No		
Estonia		No	
Finland	No	No	
France	Yes – to regulator and public, ESG policy and contribution to climate goals	Yes – to regulator and public, ESG policy and contribution to climate goals	Yes – to regulator and public, ESG policy and contribution to climate goals
Germany	Yes – ethical, social and environmental factors, at the start of a contract	No	
Hong Kong	No		
Hungary	No – voluntary codes encourage disclosure	No	
Israel	Yes	No	No
Italy	Yes – extent of ESG integration and exercise of voting rights	No	Yes if specific ESG label
Japan	No – voluntary codes encourage disclosure	No	
Lithuania	No	No	No
Macedonia	No		

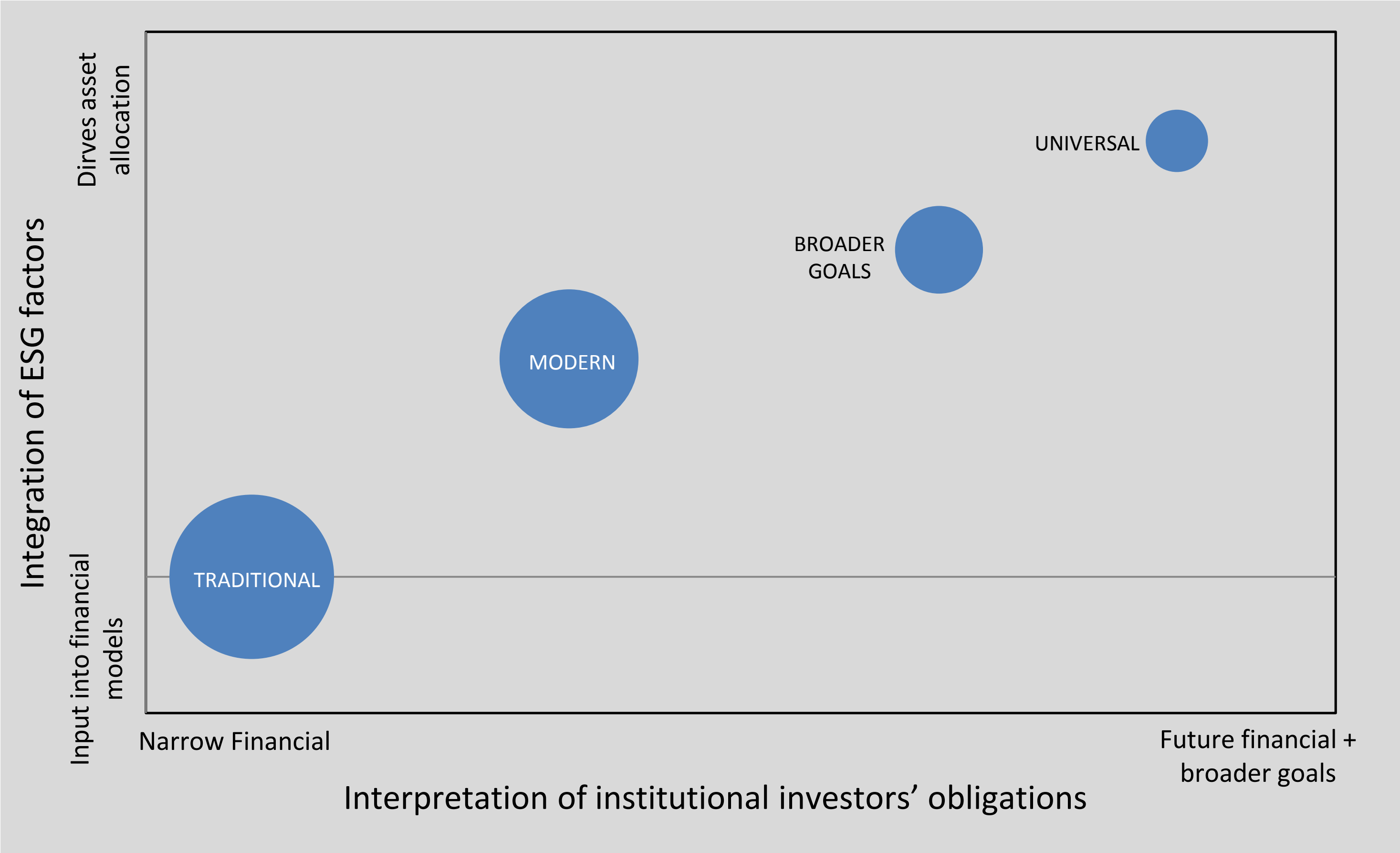
Disclosure requirements

Mauritius	No	No	No – voluntary codes encourage disclosure
Mexico	Yes	No	
Netherlands	Yes – whether an ESG policy is in place and if not, why not	No	
Poland	No		
Portugal		No	No
Slovakia	No	No	No
Spain	Yes – extra-financial risks including ESG	No	
Sweden	Yes	No – voluntary codes encourage disclosure	No – the Swedish Investment Fund Association has introduced voluntary carbon reporting for funds.
Switzerland	No	No	No
Uganda	No – voluntary codes encourage disclosure		
United Kingdom	Yes – in SIP		Yes – under the FCA's Conduct of Business Rules, produce a statement of commitment to the Stewardship Code or explain why it is not appropriate to business model
USA	No – voluntary codes encourage disclosure; DOL currently seeking public comments on ESG disclosure	No – voluntary codes encourage disclosure	No – voluntary codes encourage disclosure
IORPII	Yes – to regulator, members and prospective members		
Solvency II		No	

Stewardship codes

Jurisdiction	Name of code	Year	Regulator/industry/other
Canada	Principles for Governance, Monitoring and Shareholder Engagement	2012	Industry
EU	Code for External Governance	2011	Industry
Finland	Each pension fund must publish its own stewardship code		Industry
Hong Kong	Principles of Responsible Ownership	2016	Regulator
Italy	Stewardship Principles for the Exercise of Administrative and Voting Rights in Listed Companies	2015	Industry
Japan	Principles for Responsible Institutional Investors	2014	Regulator
Kenya	Draft Stewardship Code for Institutional Investors for Public Exposure	2015	Regulator
Malaysia	Code for Institutional Investors	2014	Industry
Netherlands	Best Practices for Engaged Share Ownership	2011	Industry
South Africa	Code for Responsible Investing	2011	Industry
Switzerland	Guidelines for Institutional Investors, governing the exercise of participation rights in public limited companies	2013	Industry
Taiwan	Stewardship Consultation	2015	Stock Exchange
United Kingdom	Stewardship Code	2012	Regulator
United States	DOL guidance on written statements of investment policy of plans includes proxy voting and other exercises of shareholder rights. Asset managers are bound by the policies of their clients.		Regulator

Institutional investors' duties – where does ESG fit in?



- Different views of financial impacts/time horizons/ /benefits/responsibilities

Practical and behavioural obstacles

- Meeting financial obligations
  - Reconciling ESG integration with accepted investment practice
  - Understanding the impact of ESG risks
  - Implementing an ESG strategy
  - Competing priorities

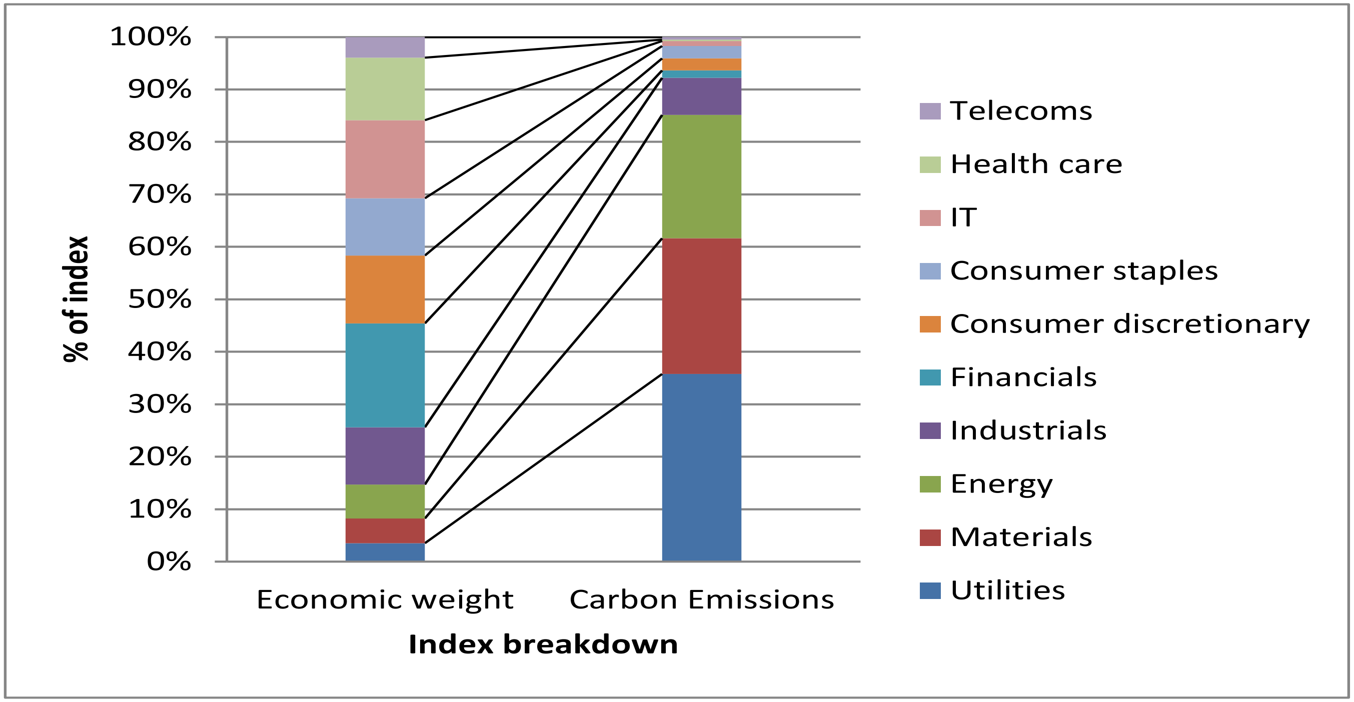
Practical barriers – data and disclosure

- Cost of ESG research (e.g. fees for SRI agencies or in-house expertise)
- Coverage of available data (e.g. lack of coverage for emerging markets, small caps, unlisted equity)
- Lack of standardisation of ESG data
- Diverging views of analyst experts (e.g. in complex industries)
- Interpretation of heterogeneous data can pose challenges (e.g. information from different sources, information overload, materiality unclear, different quality)
- Involvement of third parties that do not provide ESG information (e.g. brokers, investment advisers, asset managers)

Source: Insurance Europe

Practical barriers – portfolio construction

Market capitalisation versus carbon emissions



Source: BNY Mellon Capital Management, MSCI, OECD – data from Q2 2015

Practical barriers - modeling

- New types of analysis required to assess probability and magnitude of climate risk
- Integrating “non-financial” data into securities valuation

Broader risks associated with climate change

Type of Risk	Description	Portfolio impact
Physical risks	Damage to property or trade from climate and weather-related events	Weakened balance sheet and lost earnings of portfolio holdings; uncertainty and loss of investor confidence
Liability risks	Compensation claims by victims of climate change	Big fines levied on certain companies or sectors
Transition risks	Changes in policy, technology and physical risks lead to the reassessment of the value of a large range of assets	Disruption of business models. Disorderly re-pricing of whole sectors

Conclusion

- Clarity that ESG integration is consistent with institutional investors' obligations
  - Regulatory
  - Financial
  - Reduce potential policy conflicts

- Initiatives to overcome practical and behavioural barriers
  - Reporting
  - Modelling
  - Capacity-building

THANK YOU

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