The Origins of ESG in Pensions: Strategies and Outcomes

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Abstract

As intergenerational stewards of capital, pension funds can have many good reasons to embrace environmental, social and governance (ESG) issues in their investment practice. Yet, the particular structure of pension funds creates both a set of advantages and disadvantages for the integration of ESG. This paper reviews the historical origins, mandates, and structures of pension funds to tease out which of these characteristics enable and which impede the inclusion of ESG at pensions funds. A variety of strategies are linked to these markers to understand which outcomes are pursued, and how pension funds are uniquely positioned in achieving them.

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In an open letter to the public on November 23^{rd} 2020, the CEOs of the eight largest Canadian pension funds – the so-called 'Maple 8' – made a public pledge about their commitment to 'creating more sustainable and inclusive growth by integrating environmental, social and governance (ESG) factors into our strategies and investment decisions.' Stating that this 'is not only the right thing to do, [but] is an integral part of our duty to contributors and beneficiaries [which] will unlock opportunities […and] deliver long-term risk-adjusted returns.'[1] A similar open letter had been written only six months earlier, in March 2020, by the then-leaders of three of the largest pension funds world-wide: the California State Teachers' Retirement System (CalSTRS), the Japanese Government Pension Investment Fund (GPIF), and the largest UK pension fund, the Universities Superannuation Scheme (USS).[2] Here, the three giants outlined that 'if we were to focus purely on the short-term returns, we would be ignoring potentially catastrophic systemic risks to our portfolio' and underlining how 'asset managers that only focus on short-term, explicitly financial measures, and ignore longer-term sustainability-related risks and opportunities are not attractive partners for us.' Both letters further endorse the use of disclosure frameworks such as the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB).

Pension funds can have many good reasons to embrace a sustainability lens in their investment practice, and clearly, they are increasingly – and publicly – willing to do so. A main driver of the public move to embrace ESG in pensions is the inherent need of long-term management of corporate risks and opportunities in living up to their responsibilities as intergenerational stewards of capital. Under this consideration, it seems an absolute 'no-brainer' for pension funds to further push the sustainable capital market agenda and thoroughly integrate ESG concerns in their investment decision-making. Yet, in reality, the particular structure of pension funds creates both a set of advantages and disadvantages for the adoption of sustainable finance practices, compared with other institutional investors. While asset owners in general are often hailed as the ultimate enablers of a sustainable transition on the financial market,[3] pension funds often do not live up to that expectation. Although there is an assumption that because of their long-term focus, pensions can take a more systemic perspective than conventional investment products, many feel restricted in integrating ESG due to their fiduciary duty to secure the financial returns of their beneficiaries and related, restraining regulation.

To address this tension, we use the notion of 'social origins' (Eccles and Stroehle, 2018; Eccles, et al. 2019), to review the historical and structural characteristics of pensions funds, and to tease out the organizational and institutional enablers and inhibiters of ESG. Social origins are hereby defined as a combination of the historical and organizational origins of actors that condition the social construction and use of fuzzy concepts, such as ESG, within them. By drawing on existing literature and primary interview data, this research seeks to identify pension funds' unique characteristics and capabilities that help or impede them in contributing to a larger sustainability agenda. To do so, we examine features such as their historical origins and regulatory embeddedness, their mandates, governance structures and investment strategies. We also review the use and usefulness of sustainable finance policies, as well as pensions' convening power, advocacy and best practice sharing abilities. While drawing on the larger literature about sustainability in pension funds, we focus our structural review on the pension systems in Canada, the US, and the United Kingdom. An in-depth case study of the Canadian Public Sector Pension Investment Board ('PSP Investments' or 'PSP') supplements this structural comparison with more detailed and practical insights.

Ultimately, we ask: what is it that makes these funds so well-positioned to drive a wider integration of ESG, and why is this potential only partly being realized? With this research we hope to draw attention to both the potential that pension funds have in disseminating good practice in the wider investment community, and to the inhibiting factors which apply in this system.

Literature on Linkages between ESG and Pensions

There is a vast and growing literature which discusses aspects of how and why the topic of sustainability more broadly, and the area of ESG more narrowly, are important to be considered in the context of pension funds. In the academic literature, there is discussion of the relevance of sustainability regarding pensions' asset allocation strategies (Hawley and Lukomnik 2018; Alda 2019), their fiduciary duty and responsibility towards beneficiaries (Bird and Gray 2015; Hoepner et al. 2011; Ambatsheer and Bauer 2013), their different schemes (Hoepner et al. 2011), and their investment horizons (Ambatsheer 2014; Kecskés et al. 2020). Furthermore, pensions' relationship with sustainability is also considered in broader debates around the universal ownership thesis (Quigley 2019a 2019b; Urwin 2011; Monks and Minow 2004), moral relativism (Eabrasu 2018), collective action (Gond and Piani 2013; Woods 2011), the politicization of investors (Clark and Monk 2011), and in debates around the tragedy of the commons (Kiernan 2007).

In the following, we will focus on three clusters within this discourse which we believe to capture the most important characteristics, challenges, and opportunities for pension funds relevant to our question: the universal ownership thesis, pensions between public and private interest, and the legal structure and fiduciary duty of pension funds.

Pensions as Universal Owners. According to a Thinking Ahead Institute study in 2020,[4] the value of assets under management at the pension funds of the 22 major retirement markets were on average equivalent to 62 percent of the GDPs of their home countries. In Canada, the UK, and the US, these numbers are even higher, with 90.5 percent, 108.7 percent. and 85.8 percent, respectively in 2019,[5] highlighting just how important pension saving is in these markets. Globally, pension funds are worth just over $50 trillion USD, of which the US market represents more than 60 percent with $32.2 trillion USD in 2019. In terms of equity holdings, pension funds in the US held shares representing approximately 21 percent of the US equity market, and 11 percent of global equities. Canadian and UK pension funds held shares equivalent to approximately 19 percent and eight percent of their national equity markets value.[6]

It is this size of pension funds that makes them the archetype of universal ownership. Universal owners, according to Quigley (2019a), are commonly defined as large diversified institutional investors who have a long-term investment horizon. The concept of Universal Ownership is of particular relevance to the sustainability debate, as it postulates that these institutions, due to their size, need to take into account externalities both across their usually globally geographic portfolios and in accordance with intergenerational equity (Urwin 2011). This makes Universal Owners prone to take a systems-level lens, as threats to the planet and society as a whole are likely to affect the value of their assets in the long-term (Hawley and Lukomnik 2018).

Challenging the conventional wisdom that hedging against this risk by means of diversification is the best method, the Universal Owner thesis outlines that pension funds have a much larger and more proactive role to play in sustainably transforming the capital market system. In line with this, Clark and Monke (2010: 1731) therefore note that such institutions, ‘by reason of their size, hold such significant stakes in the market for traded securities that portfolio diversification is not an adequate means of risk management.’ Instead, academics have suggested that Universal Owners take a systems-level approach in investing (Hawley and Lukomnik 2018), to use their size for influence through active (even activist) stewardship of companies (Quigley 2019b), and to make use of their collective power in lobbying for change both through the investment chain and at the policy level (Gond and Piani 2013).

In making use of this system-level thinking by large institutional investors such as pension funds, a variety of alliances has been built to tackle so-called 'grand challenges' amongst Universal Owners. The UN-convened Net-Zero Asset Owner Alliance launched September 2019 at the UN Secretary's General Climate Summit, is but one example of how the world's largest asset owners are gathering, in an attempt to usher into a 'new and improved' era of ESG. Other such alliances worth noting are the collaborative engagement group Climate Action 100+[7] and the One Planet Initiative of Sovereign Wealth Funds.[8]

Pensions between Public Interest and Private Markets. From the early beginnings of capitalism, markets have been embroiled n deeply ideological debates about whether economic interests should take primacy over social and political ones. Most famously captured by Adam Smith's 'invisible hand,' the capitalist system was for a long time based on the assumption that individuals in a free market acting in their own self-interest would collectively, even if unconsciously, promote broader social good through market forces.

Nevertheless, the notion of full rationalization and pure focus on self-interest has often been challenged. And partly because of a majority of economic theory and academic teaching has adhered to this notion (Goshal 2005), self-interest and profit maximization have prevailed for decades and have only recently been seriously challenged, induced by external shocks such as the financial crisis, and no longer deniable systemic risks such as climate change and income inequality.

While many companies and institutions have only recently been swept up in this conversation, pension funds have had to consider the balance between public and private interest since their beginnings. Not least due to their responsibility of achieving intergenerational equity and their institutional ties to public offices, pension funds are usually both heavily regulated and can be exposed to partisan politics (Clark and Monk 2011). In the US, Monks and Minow (2004: 143) argue that pensions are so 'widely held – almost 100 million Americans have interests in employee benefit plans – [that] their pension trustees are good proxies for the public interest. It is virtually inconceivable that something would be in the interest of pensioners that is not in the interest of society at large' (see also Quigley 2019).

As a result, there is a sense that pension funds must not only serve the financial interests of their beneficiaries, but that they must also act as institutions of public interest. For example, in a challenge to short-term markets, Barton and Wiseman (2014) write in an influential Harvard Business Review article that 'big investors have an obligation to end the plague of short-termism', with pensions at the top of the list. This *obligation* postulated is based on the institutions' pan-generational responsibility, not only owed to their beneficiaries but ultimately to society at large. Additionally, influential non-governmental organizations such as Make My Money Matter by film director Richard Curtis, have recently emerged as a form of beneficiary activism, asking for 'government and industry to make sure pension funds put people and planet on a par with profit'.[9] The increasing pressure from stakeholders towards pension funds to act according to 'what is right' can also be seen in NGOs' recent demand that US pensions should divest from the private equity (PE) firm Blackstone.[10] Moves to divest from fossil fuels can also be seen as acts in the public interest, to some extent. In December 2020, for example, the state of New York and State Comptroller Tom DiNapoli said that the NYS Common Retirement Fund would divest its $226 billion from the riskiest oil and gas companies by 2025 and decarbonize by 2040. The fund is the third-largest public pension fund in the United States, and the decision follows after years of organizing by the DivestNY campaign; it was hailed as a triumph for this group as well as other activists such as 350.org.

This interesting juxtaposition of public and private interest offers both opportunities and challenges for pension funds, particularly in regard to the implementation of long-time and sustainable capital allocations. It can be beneficial, as it gives pension funds a reason to start looking into social and environmental problems, despite their reluctance to do so to the detriment of financial returns. ESG can be also considered through its integration into investment decision-making through shifts in product strategies, public collaboration and engagement, or through investment innovation. For example, new, fintech-powered pension funds are emerging with the promise of delivering net zero straight away, as opposed to the promises of decarbonization by 2030 or even 2050 which is currently offered by large, established pension funds.[11] And some larger pensions funds such as Aegon in the UK pension have started to shift net zero commitments into their default pension fund ranges in the defined contribution schemes by 2050. Some defined benefit systems, in particular Canadian funds OTPP and CDPQ,[12] have already committed to Net Zero. Such developments are a clear signal from pensions embracing systemic problems and public interest, providing potentially powerful shifts of capital.

It should be noted that public pension plans' susceptibility to political influence is sometimes seen as dangerous, where unprincipled political interference has had a harmful impact. Pension funds' biggest fear therefore is to become political instruments, particularly when related to political decisions that seek short-term advantage at the cost of long-term purpose and mandate of pension funds (Clark and Monk 2011).

In the private pension system, disengagement between members and the actual investment decision making calls into question how well pensions really represent beneficiaries' interests. Bird and Gray (2015), for example, critique the layers of managers, staff, and intermediaries that create the complex agency ecosystem of pensions and create remoteness of the agents (pensions) from their principals (the members). Finally, pension plans' liberty to act on agency through public interest in a pursuit of long-term value creation may be restricted through their tightly regulated legal structure and fiduciary duty. The need to demonstrate the financial value of ESG considerations can therefore be a barrier to adopting a perspective of system-level challenges, and even long-term value creation (Hawley et al. 2011).

To better understand these points, the following issues are central:

Legal Structure and Fiduciary Duty. To understand the relationship of pensions with ESG, one must consider the institutional design of these funds. In organizational theory, the form that an organization assumes is, at least in part, a determinant of its responsibilities, the scope of its authority, and its mandate. Furthermore, institutional design frames governance and decision-making processes and regulates the relationship of an organization with its key stakeholders (Clark 2004; Clark and Monk 2011). For pension funds, as discussed above, governance and regulation are issues of public concern with both stakeholders and the wider financial market holding an interest in the outcomes of their actions (Clark 2004). Because they have been delegated the authority to watch over their beneficiaries' retirement income, there are three critical components of their institutional design (which in itself can vary significantly by region, public vs. privat, and along other dimensions) that distinguish pension funds from other institutional investors. These are their intergenerational mandate, their special legal constraints and rules regarding fiduciary duty, and their special forms of accountability (Clark and Monk 2011).

The long-term intergenerational mandate of pension funds links to both the universal ownership thesis and the public interest in pensions funds, as discussed above. Interestingly, however, it increasingly also influences the debate around the fiduciary duty of pension funds and the legal constraints in which they are embedded. This shows that, while the concept of fiduciary duty is grounded on a relatively stable set of legal principles, the interpretation of fiduciary principles can be quite dynamic. To this point, Hawley et al. (2011) postulate that 'we are at an inflection point, where our understanding and appreciation of fiduciary duty is evolving rapidly.' They continue that 'despite a series of unexpected market shocks, prevailing theories and practices have not been fully adjusted to reflect systemic and long-term risks that threaten to undermine the security of the pension plan promise'. In their opinion, the need to rethink the concept of fiduciary duty is particularly relevant for pensions due to their recent growth in assets, the expansion of service provider influence, their exposure to system and extra-financial (ESG) risk, and the obsessive focus on short-term returns by investors, asset managers and companies collectively.

While intergenerational justice is already legally recognized in the mandate of some pension funds, it has not been translated into long-term investment horizons so far. So, while Richardson and Peihani (2015: 450) argued that 'the fiduciary duty of loyalty that governs pension fund management […] creates leverage to require trustees to be considerate of the needs of future pension plan retirees, decades from now, who may be impacted by changing economic and environmental conditions,' Quigley (2019) noted that this legal basis (which applies for some, not all, types of pensions in common-law countries) is usually unmonitored, unaudited, and not recognized in investment decision making.

Still, the legal interpretation of fiduciary duty of pensions towards short-term financial results is increasingly being challenged, with an emerging view that 'pension sector leaders should have a legal obligation to look beyond tomorrow, and to focus the capital at their disposal at the long term' (Ambachtsheer 2014). Additionally, a growing body of research contests the legal prudence surrounding fiduciary duty by demonstrating how the integration of ESG data has no detrimental financial effects (Hoepner et al. 2011), but in turn, such integration can be instrumental in driving corporate response to climate change (Woods 2011) and encourage pro-social behaviour of firms, such as the use of renewable energies and transparency towards stakeholders (Alda 2019). A clear ESG strategy can help funds avoid a debate of value over values. Finally, Wood (2011) underlined that fiduciary duty has evolved with 'societal expectation' in the past, while still noting that it would need a very principled and strong leadership from pension funds to catalyze innovation and change of practice in the industry. Organizations such as FCLT Global[13] – an NGO representative of asset owners and asset managers – advocate for this by pooling support from large industry players and providing research evidence about the commercial benefits of long-term thinking.

Exploring Origins of ESG in Pensions

Our review of the pensions literature provides a good first insight into the constitution and characteristics of these funds, and how they relate to the long-term and stakeholder orientation that is central to ESG. To fully answer the question laid out at the beginning, however, we must still examine how these characteristics relate to the implementation of ESG through strategies and outcomes that emerge.

ESG Strategies and Outcomes. When seeking to understand ESG strategies and outcomes, one must keep in mind that the concept of ESG and the underlying data can be used in different ways. Commonly, one can distinguish between a risk-focused use of ESG, value-seeking ESG strategies, and strategies that are based on normative principles and values (Eccles and Stroehle 2018; Giese et al. 2019). Not uncommonly, investors will use a combination of these approaches to establish their (or their clients') normative baselines, for example by excluding morally sensitive sectors, while at the same time running a long-term value seeking strategy through ESG integration.

Because these strategies have fundamentally different motivations, their logic can come into conflict. Exclusion, for example, is under heavy debate because it has been proven to have financial downsides (Atta-Darkua et al. 2020), while there is no real proof for its effectiveness in pushing firms to act in a more sustainable manner (Kölbel et al. 2020). It remains, however, an important ethical statement and a tool for normatively driven investors. ESG integration, on the other hand, seeks a financial upside, yet this objective can be complicated through a simultaneous exclusion strategy. As a result, a growing group of academics and practitioners are callingfor stewardship and engagement, instead of exclusion. Engagement is argued to be a more effective tool for creating behavioral changes at companies, therefore inducing both a positive impact on the world and creating a financial upside (Broccardo et al. 2020; Blitz and Swinkels 2020). Nevertheless, empirical evidence on the link between engagement and fund performance is still in its infancy (although growing), and where positive change through engagement is unlikely, investors may still prefer to exclude.

Pension Origins and Characteristics. The majority of pension funds are focused on ESG as a tool for risk mitigation and long-term financial value creation, often due to the legal structure of pension funds and the mandates under which they operate. Next we turn to how pension funds engage regarding ESG strategies and outcomes. By strategies, we mean the plan of action designed to achieve an ESG goal, and by outcomes, we mean the actions already taken in pursuit of this goal. We will not discuss whether or how these strategies and outcomes affect the financial results of pension funds.

Our literature review and expert interviews (see the appendix) allows us to triangulate several areas where pension funds' origins and characteristics are particularly important for the adoption of ESG practices (or the lack thereof). These include the historical origins of pension funds and their regulatory embeddedness; the mandate and legal structure of pension funds; the importance of corporate governance and leadership; their investment strategies and asset mix; and their ability to engage in collaborative and advocacy activities. Naturally, the degree to which these areas affect pension funds' ESG policies can differ between public and private pension funds, small vs large pension funds, and the cost structure and levels of resources at each fund. Next we elaborate on these topics.

Historical origins of pension funds and regulatory embeddedness. The nature and activity of pension funds, both public and private, are deeply embedded in national (and sometimes international)[14] regulation. As such, their characteristics have been heavily influenced by social and political developments in their respective home countries, which formed them from their founding to produce a diverse landscape of global pension funds today. The first pension system harkens back to the German Empire in the late 19th Century, where Chancellor Otto von Bismarck passed 'The Old Age and Disability Bill' in 1889. In the UK, the 'Old Age Pension Act' of 1908 was the first piece of legislation which awarded pensioners age 70+ a basic allowance (Filgueira and Manzi 2017). The rationale for these early pension systems was the Industrial Revolution's spur to the growth of the proletariat. Specifically, a system was required to mitigate old-age poverty in light of growing life expectancy and failing familial support structures (Filgueira and Manzi 2017). Until today, the main purpose of pensions has remained the provision of beneficiaries with a financial support system after their working life. At the same time, old-age systems' structure and logic has shifted from a mere public social support system to a hybrid system of intergenerational equity.

Many of today's debates about the structure and purpose of pensions have their origins in the 1990s, when there was mounting uncertainty about the sustainability of the 'Pay-As-You-Go' public pension system across the OECD. Life expectancy was increasing, and seniors were making up a greater share of the population. At the same time, the number of workers contributing to the pension plans was decreasing. Many people were concerned that pensions would not be there for them when they retired. Triggered by this self-reflection, questions about the prospects for pensions in society and their long-term mandate and responsibility became increasingly more prominent, paving the way for discussions around social responsibility and ESG. In our interview with Eduard van Gelderen, Senior Vice President and Chief Investment Officer at PSP, he described the shift in thinking as follows: 'there was a growing realization that pension plan contributors and beneficiaries were the owners of all that capital, and that pension capitalism was actually social capitalism, […] and so early questions about stewardship and governance naturally became questions about how to create a better world for pension plan members.' This realization fed into the development of what we previously described as the Universal Ownership thesis.

Apart from this global shift in perception, national legislation and social movements have also influenced the discourse about pensions' role and responsibility in society. In the US, for example, the 2002 Sarbanes Oxley Act and the 2010 Dodd Frank Act were important catalysts for the ESG movement, by creating higher scrutiny and expectations around transparency, corporate governance, and business ethics, for both companies and investors. In the UK, several social movements accelerated the conversation around ESG in the late 1990s, where organizations such as 'Ethics for USS'[15] specifically targeted pension funds to transform their investment policy. In response, USS adopted a sustainable investment policy in 1999. On the regulatory side, particularly the 2006 UK Corporate Governance Code and the 2021 UK Stewardship Code, underlined the linkage of fiduciary duty and ESG as long-term risk factors. The Canadian federal government has not yet adopted the equivalent of a Canadian Stewardship Code for investment fiduciaries, but the Canadian Coalition for Good Governance,[16] an important voice on governance matters in Canada, published seven stewardship principles in 2017. These principles are supported by many large institutional investors and are intended to help institutions investing in Canadian public equities be active and effective stewards of their investments, as asset owners and asset managers.

Mandate and legal structure of pension funds. The regulatory environment of pensions has not, however, always been a factor supporting integration of ESG into pension investment practice. In fact, while the inclusion of ESG in the wider investment market is going mainstream, pension plans still confront strict and narrow mandates which often make it difficult for them to incorporate factors other than those of financial nature.

In particular, most countries regulate pension funds both with legal mandates and the fiduciary duty of investing their members' money for the purpose of financial return without undue risk taking. This complicates the inclusion of ESG criteria in investment decisions, as it is difficult to prove that ESG criteria will impose no financial downside. Increasingly, the financial services industry advocates for the view that ESG is actually imperative for long-term risk management, but there is still limited evidence on its long-term impact on stock returns. The recent discussion around a proposed rule of the US Department of Labor (DOL) highlights the skepticism that many US regulators still have concerning ESG. In June 2020, the DOL suggested a rule that generally would have inhibited pension fiduciaries to consider ESG, unless they were able to demonstrate without doubt that these factors were not threatening the financial goal of the plan. After many industry players opposed the rule, the final regulation in October 2020 walked back the language on ESG in its ruling. While perhaps not as conservative as the US, many national regulatory environments of European pensions still focus on financial returns alone as the ultimate duty of these plans, though this picture is slowly starting to change. In the Netherlands, for example, the DNB – the main supervisor of pension funds – regards sustainability and responsible investing as part of its mandate, and therefore increasingly gives detailed guidance on the topic (Wagemans et al. 2018).

Ultimately, the regulatory environment determines the level of ambition that a pension fund can express when integrating ESG. In Canada, for example, the 'vacuum' of concrete legislation around sustainable investing permits pension funds a relatively high degree of freedom when it comes to the integration of ESG factors. In the US, by contrast, state law can support (e.g., in the case of California) or inhibit (e.g., in the case of Florida) integrating concerns other than financial ones. Public pension funds in the US are also subject to party preferences, leading to a divide in practice between funds of different states. For instance, funds like CalSTRS and CalPERS seek ambitious integration of ESG and 'activist stewardship,'[17] while the Florida Retirement System is less enthusiastic about ESG.

The extent of ESG integration will also depend on how plan sponsors interpret their mandates. In the UK, for example, the USS narrowly focuses on 'member interest,' while the Bank of England interprets its mandate more broadly. As a result, the USS takes ESG into account as part of a wider risk and long-term performance assessment, it does not exclude companies from its portfolio solely on ethical or moral grounds, or without diligent demonstration of financial unsuitability over the long-term.[18]

Finally, regulators can inhibit the increased use and integration of ESG by imposing heavy reporting burdens on pension funds. Particularly in where many small pension funds exist, reporting burdens can take away resources from funds that would be needed to develop and implement a sustainable investment strategy.

Corporate governance and leadership. Within the given mandate and legal structure of a pension fund, the corporate governance of the plan and its leadership can be vital catalysts for the adoption of sustainable investment strategies. Some pension boards face very ESG strict boundaries, while others have more freedom and/or impose certain responsibilities. Where the legal environment gives no clear guidance, as in Canada, it is arguably particularly important for pension boards and executives to enable a sustainable investment agenda and strategy. In other countries, like the UK, boards (or so-called 'trustees') are legally not permitted to give any opinion or advice on the investment strategy of a fund. Still, their guidance and standpoint on long-term risk and sustainable development can help catalyze the right decision within a fund.

Regardless of the legal environment, the question of who 'owns' the topic and who guides the organization into sustainable investment remains an important one for every pension fund. While some regulators may strongly encourage the use of ESG (as in the Netherlands and Nordic nations) and others strongly discourage it (as in the US), pension boards should always ensure that they have a clear view, strategy, and policy for long-term value creation. Depending on how permissive their legal structure, this may be more or less ambitious, but the strategy must always loop back to their identity as long-term, universal owners of capital who serve the intergenerational interests of their members. A sustainable investing strategy therefore need not start with an ambitious zero-carbon commitment, but it could begin by simply being aware and responsible stewards of their capital; using their voting rights responsibly and purposefully; influencing strategy so that pay is aligned, there is quality disclosure (e.g., by supporting standard-setting), and legislation is sought to enable long-term investing.

Investment strategy and asset mix. Under the assumption that interpretation and guidance from board and leadership allow for considerations of sustainable finance, what then enables or inhibits ESG integration when rolling out an investment strategy at a pension fund? There is still the inherent challenge that pension funds have a long-term commitment towards their members, while still facing public and sponsor expectations to generate short-term returns. This dual goal requires a thoughtful investment strategy and can be complicated by highly diversified portfolio structures and asset mixes of pension funds. On the public side, most pension funds are diversified in bonds and equities, but private pensions tend to hold more private equity, real estate, and infrastructure investments. Furthermore, many pension funds manage their assets in house, at least in part, while others use external managers. Therefore both the asset mix and management style can influence how much influence a pension board might have has on its holdings and whether or how it can assert expectations with regard to ESG.

Unsurprisingly, in public markets, investments tend to be liquid, and stewardship tools, such as voting and engagement, allow an investor to influence the direction of a company to some extent. Moreover, investors can react and escalate quickly by selling the stock if, for example, concerns about long-term value or sustainability risks appear. In contrast, investments in private equity tend to be quite illiquid. If a pension fund decides to invest either directly or as a Limited Partner, it is getting 'married' to the company for better or for worse. Therefore, before making an investment decision in private assets, pension funds must understand each investment's risk and long-term strategy. ESG considerations in private investments are therefore a matter of early assessment and then of continuous stewardship, as it is difficult to impossible of getting out quickly in case of a misalignment or scandal. Traditionally this has been aggravated by the fact that pensions usually invest in private equity for their higher expected financial returns, and so ESG sometimes become a second to last priority. More recently, a significant increase in PE 'impact funds,' where ESG is central to the strategy, can be chosen to alleviate this tension.

Fixed income or credit investments are somewhere between public and private equity when it comes to the question of how ESG concerns can be incorporated and weighed against financial interests. As with private equity, a picture of and opinion about a company's ESG performance needs to be made early on. The investor needs to feel comfortable with the ability of the management team to deal with ESG risks effectively, and to deliver long-term performance. Of course, if publicly listed, a bond can still be sold if this confidence is lost. Nevertheless, the relationship between investor and company differs. So while an investor may wage war against a company on the public equity side (for example, due to an ESG scandal), it may have every incentive to buy into the bonds of the very same company at the same time (because of the ESG scandal, it will be relatively inexpensive and promise high yields, and with full transparency). From a stewardship and ESG perspective this is, of course, counter-intuitive, but it demonstrates how the incentives and trade-offs between financial and ESG considerations can conflict across different asset classes.

Whether and how a pension fund chooses to manage its assets in house or not can also have an important influence on ESG integration. Before the 1980s, it was common for pension funds to manage their assets internally, increasing diversification. Yet internal mismanagement scandals led to a shift towards external asset managers in the 1980s and 90s. Most recently, the trend towards external managers has stalled. In the US, for example, larger state and public pension funds have returned to managing at least part of their assets in-house (Aubry and Wandrei 2020), often driven by concerns about external managers' fees and poor after-fee returns. When assets are internally managed, the pension fund has – within its mandate – full discretion over the integration of ESG. If assets are externally managed, the UN Principles of Responsible Investment (PRI) suggest that pension funds must stringently integrate their sustainable investment priorities into manager selection, appointment and monitoring (PRI 2013).

The relationship between pension funds and their asset managers when it comes to ESG can be complicated on several levels. One reason is that asset managers serve many asset owner clients with different ESG priorities. Pension funds therefore can select and review managers based on their ESG strategy, but they may only be able to influence investments in a limited way. Moreover, pension funds can decide whether to delegate their proxy voting and engagement efforts to their managers, or whether to retain those elements of stewardship in-house. If externalized, misalignments between sustainable investment principles and voting/engagement can occur, but internalization can be equally difficult due to questions of resource, language or cultural differences between a fund and its holdings.

It is also worth noting that there is an odd imbalance between the mandates which asset owners give to asset managers, and the expectations that accompany them. While pension funds are explicit long-term owners and increasingly formulate expectations of long-term risk management, including ESG, their mandates to and reviews of asset managers can in fact be quite short term. This, of course, creates perverse incentives for external managers. In Canada and Australia, most pension funds have open-term mandates with yearly reviews, but in the UK and the US, many mandates are still fixed-term and structured around quarterly as well as annual performance reviews. Longer-term mandates and performance reviews would be required, to enable external managers to effectively manage the ESG priorities of their clients.

Finally, in private equity, the impact that pension funds can have on their managers tends to be especially limited. Since such funds are often oversubscribed, General Partners (GPs) can select the clients with whom they will work, often inhibiting ESG conversations. Here, a long-term solution can only be found if pensions funds and other asset owners pool their client power to put private market managers under pressure and require standardized disclosure from the companies in the funds.

<u>Collaboration and Advocacy.</u> What role should pension funds play in the larger transformation of the capital market? As noted above, as long-term ultimate owners of capital, pension funds have an important role to play in encouraging the capital market to take a longer-term view, and to consider ESG matters. Pension funds undeniably have a stronger position than most to influence the behavior of asset managers and require best practice, yet they still have limited powers of persuasion in public and private markets. In view of this, pension managers may need to embrace both collaboration and advocacy as elements of sustainable finance and stewardship to unite their power of voice and impact.

Collaboration among pension funds is not a new idea, nor is it rare. For instance global forums such as the Net Zero Asset Owner Alliance, to more local groups such as the Maple 8, have united pension funds to communicate, share best practices and collaborate as peers. Yet more targeted coordination is needed to address the need for more long-term and effective asset manager mandates, and disclosure requirements for private equity. To this end, the International Limited Partner Association[19] represents one forum where a coordinated pension fund voice could help to establish a process for the whole private equity industry. If every pension fund were to require the same standard disclosures, this could very likely be a 'game changer,' more so than sporadic and uncoordinated individual requests. Another forum is the UK Pension Coalition for Inclusive Capitalism, which has called for a standard contract format for public external managers, and the International Corporate Governance Network.

On the advocacy side, public pension funds are closely linked to public institutions, and they also represent a large number of constituents and citizens. In this way, they have the potential for an important voice that could be used for corporate engagement through stewardship activities. They could also use this voice for national policy engagement, and to publicly support frameworks or organizations important for the advancement of sustainable finance practices. For example, CalPERS has taken a public stand to support various initiatives of sustainability disclosure standardization, such as the IFRS consultation[20] and the consultation on the foundation of the Value Reporting Foundation.[21] Also here, collaboration can be useful. The Maple 8, for example, collectively met with the Canadian security regulators a few years ago to engage on voting rights and they often send joint comment letters to regulators.

Certainly, pension funds, like any organization, must select their fights wisely. And not all pension funds can engage in every collaboration or lobby for every relevant piece of legislation. Nevertheless, carefully chosen collaboration can actually increase efficiency, and well-placed work of advocacy could alleviate other needs. Overall, there is a growing view that pension funds need to step up more and be more present and vocal as a group in many of the conversations around sustainable finance that are currently happening. As universal owners, their voice is particularly important to further discussion about systemic challenges and how the financial system can help to address them.

A Case Study: PSP Investment

The following offers an in-depth case study of PSP Investment in Canada, analyzing how the fund's historical origins and organizational characteristics link to its understanding of ESG and its responsible investment strategy. PSP Investments is one of Canada's largest pension investment managers; it is a Canadian Crown corporation that invests funds for the defined benefit pension plans of the federal public service, the Canadian Forces, the Royal Canadian Mounted Police and the Reserve Force (the 'Pension Plans'). As of March 31, 2020, PSP Investments had C$169.8B assets under management.

History and Legal Context of PSP Investments. PSP has a unique mandate and a governance structure tailored to that mandate. To understand and appreciate PSP's unique governance framework, it is important to consider the historical context that led to the creation of PSP in 1999. In the 1980s, the Auditor General of Canada released a series of reports on the finance and accounting practices associated with the various federal superannuation (pension) plans. Among the Auditor General's recommendations was a proposal to have the funds for federal employees gradually invested in marketable securities, in order to provide a sound financial basis for future benefits.

In the mid-1990s, Canada undertook an important pension reform. The key driver for this reform was concern surrounding the long-term financial sustainability of public pension plans in the face of the important expected pension pay-outs associated with an aging population and retiree longevity. These payouts were forecasted to become too high to be financed on the basis of the 'Pay-As-You-Go' model. PSP was therefore created in 1999 by an Act of Parliament (the *Public Sector Pension Investment Board Act*), to invest the net contributions received from the Government since April 1, 2000 for the Canadian Forces, the Public Service, and the Royal

Canadian Mounted Police defined benefit pension plans and since March 1, 2007, for the Reserve Force defined benefit pension plan. PSP was given a clear statutory mandate and was created to operate at arms' length from the Government of Canada.

Mandate and Nature of PSP Investments. PSP's mandate is to manage the pension funds transferred to it by the Government of Canada in the best interest of the contributors and beneficiaries, and to maximize investment returns without undue risk of loss, having regard to the funding, policies, and requirements of the Pension Plans. The Government of Canada manages and administers the Pension Plans, and PSP is the exclusive provider of investment management services to the Pension Plans. The objective of the creation of PSP was to help sustain the Pension Plans by investing the amounts contributed in a professionally-managed diversified portfolio of capital markets investments.

Review of the Nature of the Arm's Length Relationship. PSP's business and activities are managed and supervised by a board (the 'Board of Directors') whose Directors are appointed by the Government.

In managing and supervising PSP, the Board of Directors does not receive directives, mandate letters, or other instructions from the Government. Indeed, the Board of Directors alone establishes the investment policies, standards, and procedures, although in doing so, the Board of Directors is required to have regard to the funding, policies, and requirements of the Pension Plans and their ability to meet their financial obligations. This is a differentiating factor of PSP's governance, compared to certain peers whose board of directors are not involved in the setting of investment policies or who lack approval authority over investment decisions.

Investment approach. In keeping with PSP's legislative mandate, the Board of Directors approves the Policy Portfolio each year which represents the long-term target asset allocation among broad asset classes. In addition to allocations to publicly traded equities and fixed income, PSP's Policy Portfolio includes an important allocation to private asset classes such as Real Estate, Private Equity, Infrastructure, Natural Resources and Credit Investments. PSP is invested in both active and passive investment strategies managed in-house or by external managers and fund managers.

Responsible Investment at PSP Investments

ESG Governance at PSP Investments. In 2018, the Government of Canada sponsors of the Pension Plans adopted a Funding Policy which stated an expectation that PSP must describe in its Statement of Investment Policy Standards and Procedures,[22] and other publicly available documents, regarding how ESG factors are incorporated into the PSP's investment practices. It was the first time since PSP's inception that PSP was provided with an expectation on ESG matters from the Pension Plans sponsors.

In practice, PSP did not wait until 2018 to start its ESG journey. Its first Social and Environmental Responsibility Policy (now known as the Responsible Investment Policy)[23] was adopted in 2001 and has been regularly reviewed since then to adapt to a changing world and reflect its current practices. Already in 2001 it was stating that

> 'In carrying out this duty [to discharge PSP Investments' investment mandate], the board of directors recognizes that a broad range of factors may be relevant in assessing whether particular investments may properly be expected to contribute to or be detrimental to PSP Investments' ability to achieve its objects and perform its duties. Among other things, the environmental and social impact of the behaviour of corporations and entities in which PSP Investments may invest may be one of a number of relevant factors that our investment

> professionals would wish to take into account in making investment decisions for the [Pension] Plans.
>
> (…)
>
> To assist it in assessing the factors that guide and inform its investment decisions, PSP Investments encourages corporations and other entities in which it may invest to disclose regularly to their investors and potential investors the details of all policies, practices and matters that may be material to shareholder value. It is our view that reasonable and timely disclosure should be made by the corporations and entities in which we invest of their positions on all matters that may materially affect shareholder value. Where social and environmental issues are relevant and material, we would expect that they be included in that disclosure. All shareholders have a right to know about the activities of the corporations and entities whose securities they hold that are pertinent to the value of their investments.'

The direction set by the Board of Directors in 2001 was anchored in the belief that environmental and social matters were relevant to the investment decisions, when these could affect PSP's ability to provide for the financial benefit of the contributors to the Pension Plans and the ability of the Pension Plans to honor the pension promise made to their contributors. This belief was not imposed by the Pension Plans sponsors or by regulations; rather, it was shaped through dialogue and discussions between board and senior management on the success factors for a long-term investor. The belief has guided the organization over the past 20 years in shaping today's PSP's investment belief that identifying, monitoring and capitalizing on ESG factors is material to long-term investment performance. This underscores how leadership and governance have been a key facilitator of ESG integration at PSP. On this foundation, ESG developed from a risk management tool in 2001, to what is now an integrated investment decision factor.

Other ESG Enablers and Inhibitors. In discussing the possible enablers and inhibiters to the development of PSP's responsible investment approach, we found it surprising that the lack of

ESG-related regulations requiring the adoption of specific ESG practices in Canada qualified as an enabler. This induced the development of a responsible investment approach through genuine dialogue and discussion, as opposed to a responsible investment approach imposed by a regulator. It also allowed for the development of an approach aligned with PSP's mandate, its investment strategy, and its total fund perspective. This enabler helped in building a strong level of conviction about ESG risks and opportunities within the organization.

Other key enablers of ESG implementation at PSP were related to the fund's long-term investment mandate and asset mix. Being a long-term shareholder with a long-term view on economic cycles has therefore accelerated the implementation of an ESG strategy at PSP. Although adopting a responsible investment strategy for public market investments was essential, it appeared indispensable when investing in less liquid investments such as private assets. As a direct owner of private assets which it would hold for many years, PSP adopted a strategy early on that would ensure that ESG factors would be integrated in the investment process both from a risk and opportunity lens.

The principal inhibiting factor was not exclusive to PSP; rather it was a challenge facing many if not all institutional investors. Specifically, ESG must be integrated in investment models, and investors seek greater transparency on how organizations are managing their ESG risks and integrating them into their business strategy. PSP is committed to bridge the gap between an ESG qualitative narrative and quantitative factor-driven analysis, and the fund addressed this inhibiter by collaborating with peers, industry regulators, academia, and investee companies. This is one reason why PSP joined its voice with other Canadian pension plan investment managers calling on companies and investors to provide consistent and complete ESG information to strengthen investment decision-making and better manage ESG risks exposures.[24]

It was the first time that the CEOs of Canada's eight leading pension plan investment managers issued a statement, but not the first time that these organizations were collaborating to more effectively deploy resources and encourage ESG best practices.

PSP Investments' ESG Strategy. Responsible investment at PSP is an active process that addresses ESG factors across all asset classes. PSP's investment teams evaluate ESG risks and opportunities in order to make more informed investment decisions. These are supported by the dedicated Responsible Investment group housed in its Chief Investment Officer group, and it acts as a center of ESG expertise.

Conclusion

This paper discusses the social origins of ESG at pensions by reviewing the idiosyncratic characteristics of pension funds and how they enable or inhibit the integration or ESG factors. By drawing on existing literature, several interviews, and an in-depth study of PSP Investment, we show how different historical, organizational and contextual factors play a role. We argue that, in particular, there are five characteristics of pension funds which have an important impact on whether and how they can integrate ESG. The historical origins of funds and their regulatory embeddedness, their mandate and legal structure, the importance of corporate governance and leadership at the funds, their investment strategies and asset mix, and finally, pensions' ability to engage in collaborative and advocacy activities.

In reviewing these characteristics, we emphasize that pension funds are not a homogenous community, as they have different mandates, face distinct legal environments, and have different governance structures. Despite this diversity, pension funds share a common objective, which is to identify the best investments or investment strategies to generate investment returns to be able to pay pensions to their beneficiaries. In doing so, the inherent long-term investment time horizon and the diversified portfolio structures are two of the principle enablers of ESG at pension funds. Both characteristics link closely to the debate around Universal Ownership.

The growing importance of ESG and the growing evidence of their materiality in the context of system-level risks require that pension funds integrate these factors in investment decision-making. Governance structures and leadership play a critical role here by setting clear and ambitious sustainable investment policies internally and defining a sustainable investment strategy that is suitable for the fund's asset mix. The freedom of pension boards and leaders to do this can, however, be restricted through lack of clear guidance on ESG expectations from plan sponsors or regulators. Additionally, regulators can inhibit the integration of ESG by placing large reporting burdens on pension funds, therefore making ESG a question of resource.

Pension funds can be powerful forces in moving the investment market into the right direction. To do so, they should not focus on what differentiates them, but focus on what they have in common. While all pension funds have limited resources, collaboration and coordination can be key enablers for them to speak with one voice, and to make that voices heard more loudly and persuasively. Possible results of such coordination, like disclosure standards and standard mandates for external managers, can help facilitate a deeper integration of ESG in the entire investment chain.

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Endnotes

[1] https://www.investpsp.com/media/filer_public/documents/Nov_23_Maple_8_CEO_statement_Updated_for_CEO_signatures_EN.pdf

[2] https://www.gpif.go.jp/en/investment/Our_Partnership_for_Sustainable_Capital_Markets.pdf

[3] See the discussion of the 'Universal Ownership thesis' in this regard, as, for example, outlined in Quigley (2019a 2019b), also discussed below.

[4] The markets included in this study are Australia, Brazil, Canada, Chile, China, Finland, France, Germany, Hong Kong, India, Ireland, Italy, Japan, Malaysia, Mexico, Netherlands, South Africa, South Korea, Spain, Switzerland, the UK and the US. https://www.thinkingaheadinstitute.org/research-papers/global-pension-assets-study-2020/

[5] OECD Global Pensions Database, https://stats.oecd.org/Index.aspx?DatasetCode=PNNI_NEW

[6] Calculated from the value of the US equity market (12/2020: 50.6 trillion USD), the global equity market (12/2020: 95 trillion) and the equity-held percentage of pensions in the US (32.7 percent of 32.2 trillion in 2019). In the UK this is based on 11 percent of 3.6 trillion USD EUM relative to five trillion USD, and in Canada on 21.8 percent of 2.8 trillion USD EUM relative to 3.2 trillion USD. Data from Toronto Stock Exchange, OECD Pension Stats http://www.oecd.org/daf/fin/private-pensions/globalpensionstatistics.htm and Bloomberg Finance.

[7] https://www.climateaction100.org/

[8] https://oneplanetswfs.org/

[9] https://makemymoneymatter.co.uk/

[10] The divestment call was meant to signal a political message of condemnation of the events of Jan 6th, 2021, as the PE firm's founder was a supporter of former president Trump. Financial

Times, Jan 15th, 2021 under https://www.ft.com/content/0f13977f-fe5a-4db7-8996-b5496c49206b

[11] Financial Times, Jan 15th, 2021 under https://www.ft.com/content/e780606c-d46b-4e57-abcb-06add462e293

[12] OTPP is the Ontario Teachers' Pension Plan and CDPQ is the Caisse de dépôt et placement du Québec.

[13] Focussing Capital on the Long Term Global, online under https://www.fcltglobal.org/

[14] Particularly in the case of, for example, the UN Pension Fund.

[15] Today part of the organization 'Share Action,' see https://shareaction.org/uss/. Being a catalyst for this type of activism, Ethics for USS also led to the creation of 'Fair Pensions' in collaboration with WWF, Amnesty International and Friends of the Earth in 2005, see *https://www.fairpensions.org.uk/history/.*

[16] Representing the interests of institutional investors, the Canadian Coalition for Good Governance promotes good governance practices in Canadian public companies and the improvement of the regulatory environment to best align the interests of boards and management with those of their shareholders, and to promote the efficiency and effectiveness of the Canadian capital markets.

[17] https://www.calstrs.com/activist-stewardship

[18] Further reading about USS Investment Managements exclusion policy under https://www.uss.co.uk/news-and-views/latest-news/2020/07/06192020_further-reading-about-ussim-exclusion-policy

[19] https://ilpa.org/

[20] https://www.calpers.ca.gov/docs/legislative-regulatory-letters/comment-ifrs-dec-31-2020.pdf

[21] https://www.calpers.ca.gov/docs/legislative-regulatory-letters/comment-sasb-dec-31-2020.pdf

[22] https://www.investpsp.com/media/filer_public/07-contributors/00-main-page/content-5/SIPP_-_english.pdf

[23] https://www.investpsp.com/media/filer_public/02-we-are-psp/02-investing-responsibly/content-2/documents/Responsible_Investment_Policy.PDF

[24] https://www.investpsp.com/en/news/ceos-of-eight-leading-canadian-pension-plan-investment-managers-call-on-companies-and-investors-to-help-drive-sustainable-and-inclusive-economic-growth/?ref=/en/news/search?page=1_fromYear=2020_toYear=2020_category=all_q=esg

Appendix

List of interviews led specifically for this paper:

PSP, Canada; January 2021

CalSTRS, United States; January 2021

University Superannuation Scheme USS, United Kingdom; January 2021

List of other interviews drawn on:

NYCC, United States; December 2020

OTTP, Canada; December 2020

PGGM, Netherlands; December 2020

AP2, Sweden; December 2020

AP3, Sweden; December 2020

AP7, Sweden; December 2020

AWARE, Australia; December 2020