ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG): A DUTY AND AN OPPORTUNITY

A GUIDE FOR DUTCH PENSION FUNDS

BNP PARIBAS | SUSTAINALYTICS

The bank for a changing world

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Foreword by BNP Paribas Securities Services

The concept of Environmental, Social and corporate Governance (ESG) broadly captures pension funds' efforts at being responsible investors. But what ESG means exactly and how it fits into the investment process can be complex.

This guide aims to clarify and simplify the subject and to sketch out a foundation on which Dutch pension funds might be able to build a strong ESG investment structure. It aims to offer a practical approach to integrating ESG into the investment decision-making process, not least by outlining the building blocks of ESG analytics such as data and scoring.

BNP Paribas plays a key role in supporting responsible investment and sustainable investment practices. We are a recognised leader in the green bonds market and in structuring products that aid responsible investment. We lead-manage green and climate bonds for a wide range of issuers including public authorities and corporates. And we were a lead-manager for the first green bond from a commercial state-owned bank in India.

BNP Paribas Investment Partners (IP) was one of the first asset managers in Europe to adopt a responsible investment policy and to apply ESG requirements to all its investments. Our SRI products have won numerous European awards, not least 10 Novethic SRI labels, 5 Novethic environment labels, and 6 Luxflag environment labels.

As a custodian we recognise the role we can play in providing the risk and performance analytics and reporting that will help you adopt and integrate ESG policies and demonstrate their value to your organisation – be it your pension fund board or your investment committee. Our solutions help to ensure transparency and dialogue between you, the pension fund, and your asset managers.

Robert van Kerkhoff
Head of the Netherlands,
BNP Paribas Securities Services

Foreword by Sustainalytics

Responsible investment practices, once followed by a narrow segment of the investment community, are increasingly common among institutional investors. We are seeing a wider range of policy instruments being applied to a steadily expanding asset base, along with a growing body of research pointing to the efficacy of ESG integration.

Initially, Dutch pension funds considered ESG factors for ethical and reputational reasons. Today pension funds and their asset managers have accumulated significant experience with respect to addressing irresponsible behaviour by investee companies. Popular responsible investment policy instruments have included company and engagement and exclusion.

What has been newer to the community is ESG integration as a means to fulfil fiduciary duty. Dutch pension funds are already required by law (the Code of the Dutch Pensions Act) to report on how they take into account ESG considerations in their investment policy. The European Parliament will also soon vote on the revision of the IORP Directive. As currently proposed, IORP II will require pension funds to consider ESG risks and risks relating to stranded assets, and to disclose how they do this in their statement of investment principles. Apart from such obligations, ESG integration also offers, in our view, an opportunity to improve risk-adjusted investment returns.

As a proven ESG research provider, Sustainalytics works closely with hundreds of financial institutions globally. And with a strong and long-established presence in the Netherlands, we continue to support many Dutch pension funds with responsible investment policy development and execution.

We are pleased to co-author this guide with BNP Paribas Securities Services.

Alexander Rengers
Executive Director, Advisory Services
Sustainalytics

1 Introduction

Most Dutch pension funds have implemented a responsible investment policy and accumulated significant experience with various measures. Such measures include, for example, exclusion of companies with involvement in controversial weapons and engagement with companies that violate – or are at risk of violating – fundamental norms related to the environment, human rights and business ethics.

Many asset managers already offer Dutch pension funds ESG-themed or other responsible investment options. This has been driven by pension funds who wish to increase the prospect of stable long-term value for their beneficiaries and who believe that sustainability factors materially influence the risk-return profile of their investments. Increasingly however pension funds are looking for more effective ESG integration and the analytical tools to support this.

ESG analysis provides investors with a complementary way of viewing investment risk. ESG analysis looks into the current and past business practices of a company, and uses this view to measure potential risk based on the company's environmental stewardship, its corporate governance, its support of social practices, and its financial performance.

ESG integration strategies are flexible. They can be applied:

- To any asset class-including more illiquid asset classes (such as private equity and private real estate) and alternatives (such as derivatives); and
- At any number of levels of analysis, e.g. by investment fund, by region, by sector or by company.

The key challenge is in obtaining accurate and consistent data, i.e., whether the investor is able to obtain transparency on the company in which it is investing, regardless of the asset class. Another important focus is ensuring effective dialogue with the investment industry – not least asset managers and consultants.

This guide looks at the principles of ESG investing and how these can be successfully adopted. It is intended as a reference document, introducing the most important concepts and possibilities for Dutch pension funds to advance with responsible investment and ESG integration in particular.

2 What do we mean by taking an ESG approach to investing?

What is responsible investment?

Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of ***environmental, social and governance factors****, and of the long-term health and stability of the market as a whole.*[1]

Responsible Investment (RI) should not be confused with Socially Responsible Investment (SRI). SRI combines investment returns with ethical investing. In this paper, we view RI as **driven by financial rather than ethical or moral implications** and its main purpose to decrease investor risk and improve risk-adjusted returns.

ESG is a term that is used to describe a group of risks – environmental, social and governance – that are explicitly acknowledged and integrated into **the investment research and decision-making process**.

ESG integration is applicable whether managing assets in-house or using third-party asset managers. For those pension funds who use third-party asset managers, this implies incorporating ESG into the appointment process (Requests for proposals that ask questions about ESG either tailored to a specific asset class and/or broader questions such as 'Are you a signatory to the Principles for Responsible Investment?') and following it through to awarding mandates and to ongoing monitoring of the asset manager. We go into this process in further detail in Chapter 5.

[1] What is Responsible Investment? UN PRI

3 ESG integration – why is it gaining traction?

In this chapter, we consider the imperative behind ESG integration and why this approach is gaining popularity.

3.1 ESG integration and fiduciary duty

As highlighted by the PRI and the European Commission "in many jurisdictions, fiduciary duty is widely considered as imposing obligations on trustees or other fiduciaries to maximise investment returns". However, as they go on to note, this has often led to a focus on short-term returns and the neglect of ESG risks.

A broad consensus is emerging in the global institutional investment community that the focus needs to shift from short-term profit maximisation to an optimised risk-return profile for the longer term. As a result, ESG considerations are now being integrated into the core of the investment process.

Dutch pension funds have become more receptive to a wider interpretation of the fiduciary duty concept and ESG integration as a result of various developments, including:

- The Zembla television documentary "Het clusterbom gevoel" broadcast in 2007, which led to pressure from Non-governmental organisations (NGOs) on pension funds to invest responsibly
- Benchmarking and promotion of RI by VBDO (the Dutch Association of Investors for Sustainable Development)
- The Code of the Dutch Pensions Act, which entered into force in 2014, and requires pension funds to report on how they take into account ESG considerations in their investment policy[2]
- A growing awareness that proven fossil fuel reserves on the balance sheets of oil and gas producers and coal mining companies bear the risk of becoming 'stranded assets' (please refer to section 8 for more information). DNB published a noteworthy report[3] on the topic in 2016. Various institutional investors have in fact committed to reducing the carbon intensity of their investment portfolios and to allocate significantly more capital to renewable energy

3.2 ESG and the impact on long-term investment returns

There is an increasing body of evidence to suggest that companies with sustainable business models deliver improved financial returns, and that investors taking sustainability into account can deliver improved risk-adjusted performance.

For example, one report, published in 2015[4], investigating over 200 academic studies and sources on sustainability, found a correlation between diligent sustainability business practices and economic performance.

3.3 Relevance of ESG across asset classes

Historically responsible investment activity has focused on public equities, with attention given to ownership rights that are attached to shares. However, all asset classes are impacted by ESG factors. They also all need to be considered at different stages of the investment cycle. Private equity, for example, is less transparent and more illiquid than public equities and therefore requires due diligence at an earlier stage in the investment process.

[2] Code Pensioenfondsen, http://www.pensioenfederatie.nl/Document/Pensioenfederatie/Code_Pensioenfondsen.pdf

[3] De Nederlandsche Bank (2016), "Time for transition: towards a carbon-neutral economy" http://www.dnb.nl/en/binaries/Sustainable%20investement%20in%20the%20Dutch%20pension%20sector_tcm47-346418.pdf

[4] From the Stockholder to the Stakeholder. How Sustainability can drive financial outperformance. Arabesque Partners and the University of Oxford

Public equities: poor management of ESG risks can impact the long-term performance of the investee company. Pension funds using third party asset managers should engage their managers to discuss how they incorporate ESG factors into their investment management process.

Corporate bonds: pension funds hold long duration bonds to offset liabilities. Impairment in the equity value of the investee company risks driving down the mark-to-market valuation of the bond. Company default is a worst case scenario.

Sovereign bonds: these carry political, environmental, social and governance risks at the country level.

Fixed income: The UN PRI's Fixed Income Investor Guide is a useful document in understanding ESG risks for both corporate and sovereign bonds.

Real estate: can have major environmental and social implications (CO2 emissions, natural resources and working conditions) and is therefore at the centre of sustainability issues. For example, energy-efficient buildings could see valuations enhanced.

Infrastructure: similar to real estate this asset class can have major environmental and social implications. For example, infrastructure projects with commercial dependency on businesses exposed to ESG issues (such as fossil fuels and disruption of communities) could see valuations impacted

Real estate and infrastructure: The Global Real Estate Sustainability Benchmark (GRESB) is a useful reference site when considering the ESG performance of real estate and infrastructure. See www.gresb.com/

Private equity: typically, these investments have long-term investment horizons. Although pension funds generally have fewer investments in this asset class, allocations as a percentage of the overall portfolio are growing. Therefore, the impact to the portfolio (as is the case with infrastructure and real estate) can be significant and also carries reputational risk for the pension fund. Private equity managers (General Partners) should have the skills and policies in place to analyse and mitigate ESG risks.

As a useful resource, the PRI's Limited Partners Responsible Investment Due Diligence Questionnaire suggests questions that limited partners can put to general partners in order to better understand and evaluate how material ESG factors are integrated into the investment process.

The VBDO view on sustainable investing

Towards sustainable capital markets

VBDO (the Dutch Association of Investors for Sustainable Development) is a not-for-profit multi-stakeholder organisation, with a mission to make capital markets more sustainable. VBDO is also the Dutch member of the international network of social investment fora (SIFs).

Our aim is to support investors, such as Dutch pension funds, to integrate responsible investment (RI) in their investment process. Our approach entails engagement, education and benchmarking.

Engagement

We engage with more than 70 companies listed on the Dutch stock market. We do this by attending AGMs to put questions to senior management and by voting on ESG themes. Through engagement we promote sustainable practices and track the progress of companies becoming fully sustainable.

Education

RI is developing at a pace and requires pension funds to go beyond the traditional school of thought to fully understand its implications.

Lack of knowledge can be an impediment for pension funds to seriously opt in to RI. We therefore initiate knowledge building and sharing, for example by hosting seminars on subjects such as a Natural Capital Investor Guide and strategic asset allocation, and by developing courses on RI tailored to pension funds.

This ESG Made Simple Guide is, in our view, one such tool to contribute to the education process, to make Dutch pension funds more familiar with RI and inspire them to take the next steps.

Benchmarks

Benchmarks are a third instrument for VBDO. We are a founding partner of the Corporate Human Rights Benchmark, which ranks the 500 largest companies worldwide on their human rights performance.

The VBDO Benchmark 'Responsible Investment by Pension Funds' looks at the 50 largest pension funds in The Netherlands. Now in its 11th year, the benchmark aims to provide pension funds and third parties with insights into the current status of RI and to stimulate thinking on how to make further progress. It has a response rate of 100% and has proven to be very effective. As an independent benchmark it enables pension funds and asset managers to make peer comparisons. It also provides beneficiaries with input for engagement with their pension fund.

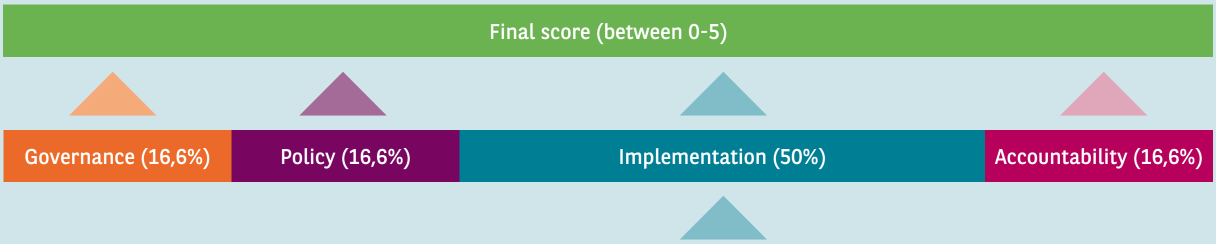
Methodology

A questionnaire is sent to a pension fund. Once completed a profile is automatically created along with a supporting score. VBDO reviews profiles, verifies supporting evidence and engages with pension funds (for example asking further questions or requesting further evidence).

On the basis of the any further information from the pension fund, VBDO assigns a final score across all assessment issues. An independent research consultancy provides VBDO with an independent review of scores based on a sample of pension funds, to assure the integrity of results.

Scoring model

The overall score is based on four pillars: Governance, Policy, Implementation and Accountability. Individual weighting percentages for all assessment issues total 100%. Not all assessment groups are weighted equally, for example Implementation represents 50% because this category in particular determines the final output and quality of RI practices within the pension fund. The final score for implementation is determined by multiplying the score of each asset class by the percentage of the portfolio invested in this asset class.



Total score on category implementation =	
Score Public equity	X % of portfolio
Score Corporate bonds	X % of portfolio
Score Sovereign bonds	X % of portfolio
Score Real Estate	X % of portfolio
Score Alternative investments	X % of portfolio

For more information about VBDO, please visit our website: http://www.vbdo.nl/en/

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4 ESG terminology and frameworks

It is useful at this point to introduce some key terminology and frameworks in support of ESG.

4.1 ESG terminology

ESG consists of three pillars – Environmental, Social and Governance. These pillars provide a lens through which to examine a company's operations, its manufacturing and services processes, its leadership and decision-making, and its interaction with the local, national or regional communities in which it operates.

Within these pillars are **ESG factors**. A non-exhaustive list is outlined in the diagram below.

Environmental	Social	Corporate Governance
▪ Carbon emissions	▪ Community relations	▪ Board structure
▪ Climate change risks	▪ Diversity issues	▪ Bribery and corruption
▪ Energy usage	▪ Employee relations	▪ Executive compensation
▪ Raw material sourcing	▪ Heath and safety	▪ Shareholder rights
▪ Supply chain management	▪ Human rights	▪ Vision and strategy
▪ Waste and recycling	▪ Product responsibility	▪ Voting rights
▪ Water management		

ESG risk assessments require metrics that capture and describe ESG factors objectively and quantitatively and apply this analysis across asset classes and investment vehicles.

A pension fund will determine which ESG factors are important to its participants and the investments made on their behalf (we discuss this further in Chapter 5).

4.2 The United Nations-supported Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact. The six Principles reflect the belief that ESG issues can affect the performance of investments and therefore must be given appropriate consideration in fulfilment of fiduciary duties. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices. The Principles are listed below along with an example action that an investor can take to implement each one.

1 We will incorporate ESG issues into our investment analysis and decision-making process.

- **Address ESG issues in investment policy statements**

2 We will be **active owners** and incorporate ESG issues into our ownership policies and practices.

- **Ask investment managers to undertake and report on ESG-related engagement**

3 We will seek **appropriate disclosure** on ESG issues by the entities in which we invest.

- Ask for standard reporting on ESG issues (using tools such as the Global Reporting Initiative)

4 We will **promote acceptance and implementation** of the Principles within the investment industry.

- Include Principles-related requirements in requests for proposals (RFPs)

5 We will **work together** to enhance our effectiveness in implementing the Principles.

- Develop or support appropriate collaborative initiatives

6 We will each **report on our activities and progress** towards implementing the Principles.

- Report on progress and/or achievements relating to the Principles using a 'Comply or Explain' approach

The 1500+ Signatories to the UN PRI include asset owners, asset managers and professional service partners.

The following frameworks are used to evaluate companies.

4.3 The United Nations Global Compact

The UN Global Compact is a strategic initiative for businesses that are committed to aligning their operations and strategies with 10 universally accepted principles in the areas of human rights, labour, environment and anti-corruption. With approximately 8,000 corporate signatories and 4,000 non-business signatories, participation in the Global Compact initiative has become a critical indicator of a company's ability to identify and manage ESG issues that may be material to investors.

4.4 The Dutch Corporate Governance Code

The Code, intended for companies whose registered offices are in the Netherlands, is built around principles and best practice provisions that regulate relations between the management board, the supervisory board and shareholders (i.e. the general meeting of shareholders). The principles reflect widely held views on good corporate governance and have broad support among stakeholders.

The Code follows the 'comply or explain' principle. Put simply, the principles and best practice provisions of the Code must be applied unconditionally or an explanation must be given for any deviation. The management board and supervisory board of a company are accountable to shareholders for the corporate governance structure that has been adopted and for compliance with the Code.

EUMEDION
CORPORATE GOVERNANCE FORUM

The Eumedion view on sustainable investing

Eumedion

Within Eumedion, pension funds, insurers and asset managers from all over the world work together to better fulfil their role as owners or co-owners of Dutch listed companies. In listed companies, ownership is distributed across shareholders who want to have their voices heard at shareholder meetings and who enter into a dialogue with company boards. Eumedion brings together institutional investors, looks after their interests as shareholders, and promotes corporate governance standards, sustainability and clear corporate reporting.

Five trillion

Established in 2006, Eumedion now has around 70 participants. Together, they manage over five trillion euros, and represent around 25% of shares in Dutch listed companies. Nowadays, institutional investors are expected to take responsibility as co-owners of the companies in which they invest.

Eumedion helps them do this by analysing all agendas of shareholder meetings. Eumedion will alert its participants in the event that a proposed agenda item contravenes Dutch legislation and regulations, the Dutch corporate governance code or the Eumedion Corporate Governance Handbook.

Furthermore, Eumedion maintains dialogues with listed companies to enhance corporate governance, environmental and social performance and strategy of these companies. Eumedion also critically examines financial and non-financial reporting by companies and, where necessary, makes suggestions for improvement.

The Hague and Brussels

Eumedion also represents the interests of institutional investors when it comes to legislation and regulations. For example, Eumedion follows policy developments in The Hague and Brussels closely and makes proposals for improvements. Additionally, Eumedion participates in various institutions, such as the Dutch Corporate Governance Code Monitoring Committee and the Dutch Accounting Standard Board.

Daan Spaargaren
Sustainability and Responsible
Investment Expert at Eumedion

Eumedion best practices for engaged Share-ownership

Eumedion uses the 'Best Practices for Engaged Share-ownership' as a guide for its participants. These 10 principles offer Eumedion participants guidelines for engaged ownership. For example, the Best Practices call for clear voting policies, public disclosure of voting behaviour, and guidelines on integrating environmental, social and governance factors when exercising shareholders' rights.

5 Integrating ESG into the investment process

5.1 Investment beliefs

Many ESG practitioners approach ESG integration by first setting out their investment beliefs. In doing so, a pension fund will be influenced by its organisational culture, the policies and practices of its sponsor, and additional key elements such as whether it is a signatory to the PRI. As such, there is no one-size-fits-all set of beliefs.

Whilst all ESG factors are relevant, investment beliefs will determine which factors are most important to the pension fund. Investment beliefs will also drive conversations with asset managers, consultants, and in some cases with the investee company.

In its strategic investment framework 2015-2020, Pensioenfonds Metaal en Techniek (PMT) offers a good example of investment beliefs supported by more detailed responsible investment principles[5]. The framework includes ten investment beliefs, one of which underpins its approach to RI "*Investments can yield solid returns only if the economy is allowed to evolve responsibly.*" PMT then goes on to define ten responsible investment principles.

PMT's Responsible Investing Principles:

- *PMT seeks to generate solid and responsible investment returns. PMT will invest according to ESG criteria: Environment, Social, and Governance.*
- *PMT will consider the social impact of its investment policy. [...]*
- *PMT seeks to contribute to economic stability and sustainable economic growth. [...]*
- *PMT will engage with companies involved in bribery, corruption, cartels, extortion or any other form of market abuse. [...]*
- *PMT will not, directly or indirectly, invest in companies that manufacture products in violation of international treaties signed by the Netherlands.*
- *PMT considers ESG risks when investing, where possible. [...]*
- *PMT respects the Universal Declaration of Human Rights and related treaties. [...]*
- *PMT wants the businesses it invests in to comply with the OECD Guidelines for Multinational Enterprises. [...]*
- *PMT wants the businesses it invests in to have a solid corporate governance framework in place. [...]*
- *PMT will make well-informed choices. In the case of any doubt or dilemma, it will make a careful and well-considered choice, based on its own responsible investment policy.*

The ESG policy

Investment beliefs are a key part of an ESG policy. The policy lays out how – in practical terms – the pension fund will integrate ESG into the investment process. Pension funds may wish to consider the policies and practices of their sponsor and how aligned they need to be with these.

An ESG policy could include:

- Those ESG factors which are important to the pension fund e.g. board structure, supply chain management
- How the pension fund will work with asset managers
- How the pension fund will collaborate with others
- Which ESG factor has the biggest potential impact on a particular investment e.g. countries with weaker social welfare practices may require a greater focus on the 'S' than the 'G'
- Key Performance Indicators (KPIs) that the pension fund might use to measure ESG performance e.g. carbon emissions or governance scores

[5] PMT, Strategic investment framework 2015-2020

5.2 The investment process

Investment beliefs and ESG Policy

Investment Objectives

- Asset Liability Management (ALM)
- Asset allocations
- Statement of Investment Principles (SIP)

Implementation

- Mandate design
- Manager selection
- Risk appetite
- Portfolio construction
- Benchmarks
- Stress testing

Monitoring

- ESG analytics
- Attribution
- Exposure analysis
- Risk analysis
- Performance
- Manager reviews

Guiding principles – investment beliefs and the ESG policy

Investment beliefs and the ESG policy should guide the investment process as shown in the diagram above. As such, they will influence investment objectives, manager selection and the ongoing dialogue between the pension fund and its asset managers.

Step 1: Investment objectives

The first stage is for pension funds to set the long-term objective(s) of the fund. This takes into account the pension fund's liabilities and current funding position, alongside longevity risk and liquidity requirements.

The pension funds will then define the investment policy of the pension fund in the Statement of Investment Principles (SIP) or similar investment strategy statement. The investment beliefs or responsible investment principles are embodied within the SIP, which sets out how the pension fund will be governed and how the assets are to be managed. The SIP also specifies the strategic asset allocation of the pension fund.

Step 2: Implementation

Manager selection

It is critical at this stage for the pension fund to articulate its ESG expectations of a potential asset manager. This can be achieved using appropriate questions about responsible investing. A pension fund will likely want to discuss ESG expectations through the entire asset manager selection process (initial meetings and beauty parades). The pension fund may also wish to put questions to the portfolio manager (as opposed to putting them solely to the ESG analyst). Managers should adhere to the investment beliefs of their client as they apply to the implementation of the mandate. Key ESG requirements should be documented within the Investment Management Agreement (IMA).

One invaluable reference in creating your questions is the UN PRI's *Aligning Expectations – Guidance for Asset Owners on Incorporating ESG Factors into Manager Selection, Appointment and Monitoring*.

Manager selection questions

There are numerous ESG-related questions that you might use in the manager selection process. Key discussion areas will include:

- **RI policy and governance** e.g. what motivates you (the asset manager) to look at ESG issues (rationale behind responsible investing)?
- **ESG resources** e.g. How are your portfolio managers incentivised to incorporate ESG factors?
- **ESG integration** e.g. How are ESG factors incorporated into the investment analysis and decision-making processes?
- **Voting and engagement** e.g. Do you have examples of engagement/where you have engaged a company and what you have achieved?
- **Monitoring** e.g. How often and through which communication channels (meetings, written reports etc.) are RI activities reported to pension funds?

In the selection of asset managers, the following are areas where you may wish to check your understanding of how they integrate ESG as part of their portfolio construction:

- Analysis of investments
- Benchmark selection e.g. using a standard or ESG 'tilted' benchmark.
- Asset allocation optimisation (does the asset manager consider ESG factors in how they positively or negatively weight the portfolio?)
- Stress testing on ESG issues e.g. real estate – new energy efficiency requirements and the impact these might have

Step 3: Monitoring

This final stage involves monitoring the progress of investments to ensure that the pension fund's risk and return objectives are being met and that the stated investment philosophy – the investment beliefs – are being met.

There are various sources of ESG reporting. In the first instance the pension fund should be engaging asset managers to provide more detailed ESG reports. Investment consultants also provide investment reports and manager performance reviews. Pension funds can also decide to invest internally to develop their own reporting.

There has been growing demand for independent third party performance and risk analytics, which can now include ESG metrics. Some global custodians are able to provide this independent analysis as part of their risk and performance analytics to pension funds.

This brings us neatly to our next chapter on data.

6 ESG – data and scoring

6.1 The importance of data

ESG data generally supports contextual analysis and provides a means of measuring and comparing companies' ESG performance across a consistent framework. Since disclosure around ESG practices is not standardised, collecting the data can be a complex process. It is important that the data used within the investment process is accurate, is sourced independently of the company, and is analysed in the context of financial risk.

Whether analysing a particular company, assessing a portfolio or looking at the entire assets of the pension fund, all require a disciplined approach to gathering and normalising a broader data set.

A number of issues need to be considered:

- Which ESG data are needed?
- What asset coverage is available?
- Who can provide the data?
- How up-to-date are the data?
- How can the data inform investment risk analysis?

Let us now look at best practices for collecting, analysing, and using ESG data and how this can augment the stewardship activities of the pension fund.

6.2 Creating ESG scores

The starting point for ESG analytics is to score each investee company.

So what is an ESG score?

The **ESG score** is an expression of all of the **Environmental, Social, and Governance factors** combined with some economic factors. Individual company scores can then be aggregated to calculate the portfolio score, the sector score, the regional score or in fact the score for any characteristic data point, such as duration.

The ESG score for a company is based on three categories; E for Environmental, S for Social and G for Governance. Each category has numerous underlying factors that require data points on the company. Data service providers, like Sustainalytics, are able to collect and validate core underlying ESG company data. The following table will provide some examples of those research questions used to collect data points. Note that their importance from a financial risk perspective will vary by sector and by country.

Environmental
Is the company seeking to reduce its emissions in a measurable way?
Does the company measure its water/energy waste? Does it have targets to reduce this?
Social
Does the company have measurable goals in place to increase gender diversity in its workforce?
Does the company perform due diligence to ensure that human rights are respected and protected?
Governance
Are all non-executive board members independent?
Do the common equity shares of the company have equal voting rights on a per share basis?

For each factor, the relevant answer is selected. Each answer – e.g., "the company has a system to monitor supplier compliance with social standards" or "executive compensation is explicitly tied to ESG performance targets" – corresponds with a raw score on a specific scale (0-100, for example). The raw score is then multiplied by a weight and the weighted indicator scores aggregated to create an overall ESG score.

Importantly, ESG scores need to be based on objective, consistent, and comparable data points. Information should be collected and verified independently of the company to ensure the integrity and validity of the data. It is therefore important that, when gathering ESG data, information does not always come directly from the company. For instance, it is considered best practice to gather company information, not only from a corporate website and reporting, but also from independent media and NGO reports. It is also important that ESG research providers actively seek feedback from each company being assessed.

ESG scoring methodologies vary across research providers, but generally the data collection process and sources are similar and just about all providers assess companies' ESG performance overall and within each of the E, S and G pillars separately.

The ESG score can be analysed by its E, S and G elements. This additional depth allows for further nuance when applying this information to your investment analysis. For example, a company with a high total ESG score may have very high individual scores in both the Social and Governance categories, but a low Environmental score. In another example, two companies may have a similar Environmental score, but while one company has only limited disclosure and no significant controversies, the other has more extensive disclosure but also significant controversy exposure. This gives greater insight into the ESG risks associated with underlying investments. While the aggregated ESG scores provide for a convenient starting point for ESG analysis, a closer look at the individual pillar scores can provide more nuanced insights.

6.3 ESG data provision

Some ESG data service providers are developing new processes and methodological frameworks. This is an important step in obtaining robust data so that ESG reporting and analysis can be integrated into the investment process in a similar vein to other more established risk measures, such as Value at Risk (VaR) or credit ratings.

Many asset managers have been incorporating elements of ESG research into their investment and stock selection process for a number of years. However, until recently, ESG reporting had not been separately requested by pension funds as part of the manager selection process or embedded within the Investment Management Agreement (IMA).

Asset managers should provide ESG reporting for their specific fund or mandate. However, this still leaves the challenge of data aggregation across all portfolios. Custodians are already data consolidators for pension funds and provide a range of valuation services and risk reporting. They are therefore well placed to extend their services to incorporate ESG factors into a broader investment and risk reporting framework. Providing a view across all investments from all asset managers allows the pension fund to truly understand their ESG risk profile.

Key questions to ask your custodian

- Which ESG data do you have access to at the individual company level?
- Can you build ESG portfolio level scores based on individual asset class scores?
- Can you provide reporting on 'E, S & G' factors separately?
- Do you have access to, and the ability to score, both standard and ESG-specific benchmarks?
- Can you provide asset level ESG scoring for pooled funds? Do you have look-through to the underlying investments?
- Can you provide ESG reporting at both the portfolio level and also across all portfolios/investments at the pension fund level?

6.4 Data aggregation and analysis

Using asset level scoring, it is then possible to aggregate data to allow:

- Company analysis
- Portfolio analysis (to facilitate benchmark comparisons)
- Pension fund analysis (to understand risk by sector or by region)

6.5 Company analysis

Pension funds may want to analyse an investee company using ESG factors for a number or reasons, not least to better understand the company's drivers, its involvement in key businesses, and its exposure to potential controversies. This information can support the pension fund to take a proactive and informed stance on key issues of materiality. It can help the pension fund to assess both best-in-class and worst-in-class companies, conduct peer comparison, and undertake longer-term trend analysis to assess changes in ESG risk factors.

6.6 Portfolio analysis and benchmarking

By applying ESG data to existing standard benchmarks, the pension fund can measure its portfolios against the same standard market benchmarks currently used to measure performance. For example, if the pension fund measures equity performance against the MSCI World, it can continue to use this same benchmark, but this time containing an ESG data set, to facilitate a comparison of the portfolio's ESG score with the MSCI World. Conversely, a pension fund could choose customised ESG indices for a more effective comparison. For example, if a pension fund has excluded thermal coal stocks from its portfolio, it may wish to measure ESG performance against an index that has been optimised to exclude thermal coal stocks.

6.7 Pension fund level analysis

Assets can also be aggregated at the level of the pension fund. These aggregated scores can then be used to review specific sectors or regions either at the individual portfolio or pension fund level.

This level of analysis can help identify those areas where the portfolio is underperforming the benchmark. This helps provide an independent view to inform discussions with asset managers.

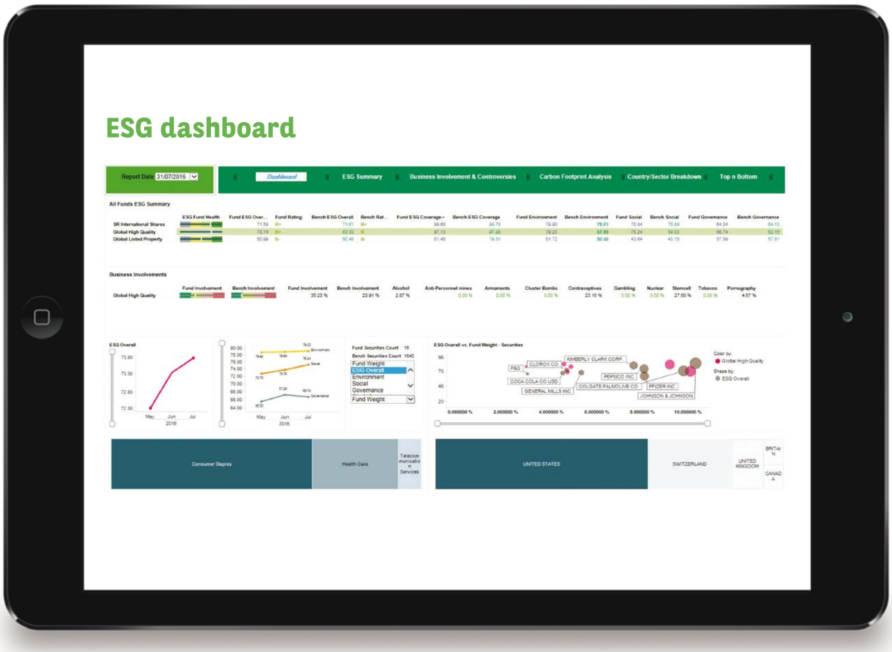
Some sustainable strategies at the individual manager level can then be considered at the total pension fund level. For example, if the goal is to reduce the carbon footprint of the overall portfolio, the pension fund can identify sectors that generally have higher carbon footprints. These reporting tools can provide an insight to the overall health of the portfolio and help pension funds meet their fiduciary responsibilities.

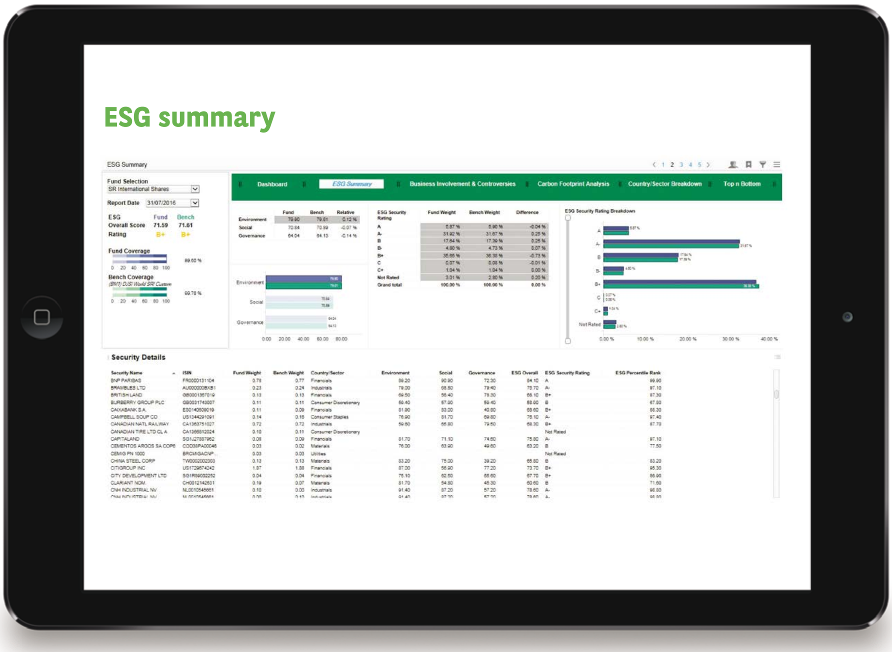
6.8 ESG Risk Analytics

In support of the data challenge, BNP Paribas Securities Services has created ESG Risk Analytics – a new reporting solution that brings ESG risk, economic performance and market risk into a single view. ESG Risk Analytics helps pension funds to:

- Integrate ESG risks into investment-decision making processes (whether assets are managed in-house or externally)
- Assess the extent and nature of company controversies
- Benchmark and measure a portfolio against chosen ESG criteria
- Communicate ESG risks to key stakeholders
- Comply with international standards (such as the PRI) and stewardship codes

Data is independent, objective and publicly-sourced.





6.9 Checklist – am I ESG-ready?

The checklist below asks some key questions in support of the pension fund's ESG journey.

- Is my rationale for pursuing Responsible Investing clearly understood by my Board and investment committee?
- Have we drawn up and agreed our Investment Beliefs and our ESG policy/strategy? Do our investment beliefs capture our view of the risks relating to ESG?
- Which ESG factors are material to a specific investment strategy/sector/theme that we wish to mandate and/or pursue in-house, and will create value over the long-term?
- Have I asked my asset manager(s) about what type of ESG reporting they can provide?
- Do I have the information that I need to evaluate my asset manager? Is there an ESG rating for my asset manager (for example by the PRI or by fund ratings agencies)?
- How will I aggregate data coming from multiple asset managers?

7 Climate change, carbon risk and carbon pricing

> "If you assume that there is an instinct for freedom, and there are opportunities to change things, there's a chance you may contribute to making a better world."
>
> *Noam Chomsky*

Carbon dioxide emissions and other greenhouse gases affect the Earth's climate negatively, which over time leads to an increase in average temperatures.

The Paris Agreement and the French law on 'energy transition towards green growth'

In December 2015, at the Conference of Parties 21 (COP21) Paris climate conference, 196 nations agreed to work towards a low-carbon, climate-resilient future. The key actions arising from the Paris Agreement are to:

- Keep any increase in global temperatures below 2°C and pursue efforts to limit to 1.5°C
- Define post-2020 climate actions and to evaluate progress every five years
- Finance climate change adaptation measures in vulnerable countries

France has since become the first country to introduce legislation in support of the Paris Agreement. Its new law is designed to accommodate the 'energy transition towards green growth'. Investors with assets in France now face legal requirements to report on their progress with respect to ESG integration in general and climate-related risk management specifically. While such legal requirements have not been imposed in the Netherlands to date, the DNB has started engaging with the sector and this could ultimately result in new regulation.

The environmental cost of emissions is, to a limited extent, taken into account in current valuations of listed companies. If that changes, climate change has the potential to impact investments and will need to be considered as a serious financial risk. Regulators such as the Financial Stability Board (FSB) and DNB are particularly concerned about the transition risks associated with climate change. While there is a strong consensus that the transition to a low-carbon economy needs to happen, the process should be managed to avoid disruption to the financial system.

If society wishes to stay well below 2°C of global warming (relative to pre-industrial levels), many proven fossil fuel reserves will need to be written off. If we exceed the 2°C warming limit, the societal costs of climate change are expected to increase rapidly, and we would no longer be able to afford to burn more fossil fuels. Proven reserves will become 'stranded assets'. Furthermore, if companies such as car and aircraft producers do not prepare for the low-carbon future, they also risk losing business. Institutional investors are concerned about the long-term value of their assets and have started to engage with and even divest from companies in carbon-dependent industries.

New tools are being developed with a view to better understanding and solving the ESG risk of climate change to financial investments.

7.1 Carbon risk management

Carbon and climate change have emerged as a primary ESG issue for investors. Increasingly fiduciary duty and in some cases regulations require that investors analyse and understand their risk exposure to a carbon-constrained future.

There is no such thing as a single aggregate carbon metric to capture all aspects and impacts of climate risks. However, two distinct approaches are emerging that serve different purposes: carbon footprinting of securities and portfolios, and carbon stress testing of portfolios.

Carbon footprinting

Carbon footprinting typically uses the intensity of scope 1 and scope 2 emissions[6] to determine the size of a portfolio's carbon footprint, which can be compared against a benchmark, as well as individual securities' carbon contribution to the portfolio's carbon footprint.

Approximately 50% of developed markets' large and mid-cap public companies report scope 1 and scope 2 emissions and 20% of emerging markets – meaning much data is missing. There are sophisticated estimation models which can predict a non-reporter's emissions based on their size and business model. Although these models allow virtually unlimited coverage, their estimations are, however, imperfect.

Carbon footprinting can be used to obtain an overall picture of the exposure of different investment strategies to greenhouse gas emissions. It can be a useful tool for high level communication or reporting and can be used as a starting point for shaping exclusion and engagement strategies. As a result of carbon footprinting, various large high-profile institutional investors have already committed to de-carbonising their investment portfolios.

While carbon footprinting is a useful first step for investors to assess their exposure, risk managers are seeking metrics with more predictive power. For this reason, the FSB's Taskforce on Climate-Related Disclosures is investigating the level of company disclosure required by investors so they can better manage climate-related risks. ESG research providers, such as Sustainalytics, are working with various institutional investors to develop more insightful metrics.

[6] Scope 1 refers to direct emissions. Scope 2 refers to indirect emissions related to purchased energy. Scope 3 is the term used for all other indirect emissions. Reporting on scope 1 and scope 2 is more common and more consistent than reporting on scope 3.

Carbon stress testing

Another way to approach the management of carbon risks is through portfolio stress testing. While only some provisions of the Paris Agreement are legally binding, the political will to mitigate greenhouse gas emissions appears strong. National policy agendas and the Intended Nationally Determined Contributions (INDCs), particularly around energy and carbon, are a signal of that commitment. These policies also provide a yardstick against which investors can assess how much regulatory change might pose performance risks for their equity portfolios.

BNP Paribas has worked with Avalerion Capital to develop a new approach to managing climate change risks within investment portfolios. Moving beyond assessing absolute carbon emissions, three policy factors and their impact on profit before tax (PBT) are considered:

- Carbon pricing;
- Energy efficiency policies; and
- Energy subsidy policies.

At the heart of this stress-testing work are three fundamental questions:

- Does climate change policy pose material risks to the expected future performance of equity portfolios? And if so, which of the above three factors is most significant?
- At what tracking error and performance 'costs' can equity portfolios be re-balanced, without any material loss of performance, to mitigate these risks?
- How can institutional investors build 'better' betas to mitigate losses driven by climate change risks?

Our analysis shows that stress-testing and rebalancing portfolios on the basis of the expected profit-and-loss impact due to carbon prices, yields different results to 'de-carbonising' portfolios using absolute emissions. Managing carbon risk by using absolute CO2 emissions by companies does not buffer a portfolio against financial impacts from future carbon price increases. Therefore, measuring and managing carbon footprint alone is not enough to mitigate investment risk. Rather, a pension fund needs to also understand the risk posed by carbon pricing.

Finally, analysis also shows that carbon factor investing portfolios can be created without 'sacrificing' annualised returns (the 'costs' are a tracking error of ~2%).

DeNederlandscheBank

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The DNB view on sustainable investing

De Nederlandsche Bank (DNB) is an independent central bank, supervisory authority and resolution authority. Our role is to work towards financial stability and thereby contribute to sustainable prosperity in the Netherlands. The focus on "sustainable prosperity" is vital for current and future generations and for us it means that we do not focus our activities solely on economic issues but that we also consider social and environmental factors.

This long-term perspective is one that DNB shares with the pension sector. For many years the pension sector has worked for sound pension funds and in this context the topic of sustainable investing has become increasingly important. In fact, we believe that sustainable investing can play a key role in four investment areas.

The prudent person principle (Pensions Act § 135) requires pension funds to make investment decisions in the interests of active and former members, and pensioners. This means that pension fund managers and their administrators need to carefully consider their decisions. They can only achieve this if they adopt a long-term perspective that includes a wide range of issues such as the potential consequences to investments of the transition to a low-carbon economy.

The value of stakeholder dialogue. Pension funds need to obtain clarity from various stakeholders regarding the objectives and principles of the pension fund's investment policy (Pensions Act § 102).Sustainability considerations can be an important part of this clarification process.

Transparency on sustainable investing and its potential impact on returns. DNB supports the explicit transparency requirements regarding sustainable investments as stipulated in the Pensions Act. Our recent study on sustainable investment in the pension sector (see box below) shows that the use and disclosure of ESG information remains a challenging issue.

Risk management is critical. Financial institutions must be able to manage all relevant risks in their operations. This is also required by law (Pensions Act § 143, sound and ethical operational management). This means that relevant ESG risks are managed and integrated into an investment policy.

Study on sustainable investment

In 2016, DNB conducted a study on Dutch pension funds and sustainable investing. The impetus for this study was an amendment to the Pensions Act requiring a pension fund to disclose in its annual report, its investment policy towards the environment, climate, human rights and social relations (Pensions Act § 135 (4)).

The study reveals that pension funds are continuing to develop their approach to sustainable investing. In recent years, the percentage of pension funds that have embedded sustainability into their investment beliefs has risen from 45% in 2013 to 74% in 2015. This will further formalise sustainable investment within the *investment policy* and, in the future, have an impact on portfolios. DNB consequently sees a shift from ex post (results) driven reputation management to a more ex ante (forecast) integration of sustainability in financial analysis.

DNB has also looked at the ways in which pension funds invest sustainably. There are significant differences. Some pension funds have a limited exclusion policy, while others use *best-in-class* selection and become active shareholders. There are also funds working on the continued integration of ESG factors in all investments and combining this practice with a themed approach, such as policies aimed at CO2 reduction or improvements in labour rights. The study reveals that a themed approach is predominantly used by larger pension funds because these are more likely to have the appropriate internal resources and knowledge (as well as being supported by major pension fund service provider) to develop a policy for responsible investing.

Involving beneficiaries in the responsible investment policy, as stipulated in § 102a of the Pension Act, continues to be a challenge for many funds. Ultimately, each pension fund must create an investment policy that meets its objectives and principles within the available control frameworks. This is a balancing act and a dynamic process. A responsible investment policy should be supported by the beneficiaries and meet the goals of the pension fund.

Integrating sustainability into an investment policy is still a new concept. One problem lies in the area of disclosure and in using ESG factors using non-subjective data. Further international standardisation of ESG factors will help to improve a pension fund's understanding of the potential impact of such factors on its investments.

8 Conclusion

Pension funds aim to be responsible investors. To effectively integrate ESG into their decision-making, they should enlist the support of their asset managers, custodian and consultants.

ESG integration is in line with fiduciary duties. Early engagement with asset managers will ensure alignment between the investment beliefs of the pension fund and the activities of their asset managers.

ESG integration is not at the expense of performance. It is an additional lens to effectively manage and measure portfolio risk, which should lead to better investment outcomes.

Studies demonstrate that assets will be impacted by climate change. As a result, strategies for testing and immunising the portfolio from these impacts will become increasingly important.

Regulators will not lie idle. ESG-related regulation will continue and will drive change which in turn will impact corporate and investment performance.

Custodians such as BNP Paribas Securities Services, working with global ESG research providers are able to provide robust and reliable ESG reporting and future innovations point to the development of dynamic tools to support ESG integration and the use of data and scoring.

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