PENSIONS AND LIFETIME SAVINGS ASSOCIATION

May 2016

ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG)

MADE SIMPLE GUIDE

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It is not investment advice.

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FOREWORD

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 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.

As one of the world's leading financial institutions, BNP Paribas plays a key role in supporting responsible investment and sustainable investment practices. The Bank is a recognised leader in the green bonds market and in structuring products that aid responsible investment. During 2015 we lead-managed green and climate bonds for a wide range of issuers, including local authorities, corporates and supranationals. And we were a lead-manager in the first green bond from a commercial state-owned bank in India.

BNP Paribas Investment Partners (IP) was also 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 trustee board or your investment committee. Our solutions help to ensure transparency and dialogue between you the pension fund and your asset managers.

PATRICK COLLE
CEO BNP Paribas Securities Services

1 INTRODUCTION

ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG) ANALYSIS PROVIDES INVESTORS WITH A COMPLEMENTARY WAY OF VIEWING INVESTMENT RISK. ESG LOOKS INTO THE CURRENT BUSINESS PRACTICES OF A COMPANY, AND USES THIS VIEW TO MEASURE RISK BASED ON THE COMPANY'S ENVIRONMENTAL STEWARDSHIP, ITS CORPORATE GOVERNANCE, ITS SUPPORT OF SOCIAL PRACTICES, AND ITS ECONOMIC PERFORMANCE.

Many UK pension funds – with the support of their asset managers – already integrate ESG factors into their investment decision-making framework. There are two reasons why: they wish to increase the prospect of stable long-term value for their members and they believe that sustainability factors materially influence the risk return profile of their investments.

The fiduciary aspect of ESG is becoming clearer and more of a focus. Trustees are under greater pressure from the Government following the Kay Review[1] to take greater ownership and responsibility seriously. Furthermore, the long-awaited report by the UK Law Commission on the fiduciary duties of investment intermediaries found that consideration of ESG factors by pension fund trustees is entirely consistent with their fiduciary duty to beneficiaries.

The report concludes that trustees should take into account factors which are financially material to the performance of an investment. Where trustees think ethical or environmental, social or governance (ESG) issues are financially material they should take them into account.[2]

This also frees fiduciaries to take ethical issues into account where this does not imply a significant financial detriment to the pension fund and they have confidence that this would support member views.

For many ESG practitioners this provided the clarity and catalyst needed to identify ESG as an issue which needs attention and should be considered along with other established fiduciary responsibilities.

ESG as an approach is flexible. It 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** eg by investment fund, by region, by sector or by company.

The key challenge is in obtaining accurate and consistent data ie whether the investor is able to obtain visibility and 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 Made Simple Guide looks at the principles of ESG investing and how these can be successfully adopted.

1 The Kay Review of UK equity markets and long-term decision making. July 2012
2 The Fiduciary Duty of Investment Intermediaries. The Law Commission. 1 July 2014

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WHAT DO WE MEAN BY TAKING AN ESG APPROACH TO INVESTING?

2.1 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.*[3]

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 factoring in ESG from 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 UN PRI signatory?') through to awarding mandates and to ongoing monitoring of the asset manager. We go into this process in further detail in Chapter 5.

ESG IS A TERM THAT IS USED TO DESCRIBE A GROUP OF RISKS

3 What is Responsible Investment? UN PRI

3
ESG – WHY IS IT GAINING TRACTION?

IN THIS CHAPTER, WE CONSIDER THE IMPERATIVE BEHIND ESG AND WHY THIS APPROACH IS GAINING POPULARITY.

3.1 ESG AND TRUSTEE FIDUCIARY DUTY

As highlighted by the United Nations-backed Principles for Responsible Investing (UN 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.

This landscape is now changing, driven by various factors including:

- The Law Commission, which has clarified that financially material ESG issues should be taken into account by trustees;
- A general acceptance that ESG can enrich the overall risk measurement and management process (is complementary to traditional types of investment risk analysis); and
- The financial impact of ESG issues on long-term investment performance, which has become clearer.

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 parts 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.

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.

For **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 implications (CO_2 emissions and natural resources) 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 implications. For example infrastructure projects with commercial dependency on businesses exposed to ESG issues (such as fossil fuels) could see valuations impacted.

For **real estate and infrastructure,** the Global Real Estate Sustainability Benchmark (GRESB) is a useful reference site when considering the ESG performance of these asset classes. See **www.gresb.com**.

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

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.

For **private equity,** one useful reference is the British Private Equity and Venture Capital Association's (BVCA) Responsible Investment guide.

3.4 COP21 AND CLIMATE CHANGE

In 2015, at the COP21 Paris climate change conference, 196 nations adopted by consensus a climate agreement. The key actions arising from COP21 are to:

- Keep any increase in global temperatures below 2ºC and pursue efforts to limit to 1.5ºC;
- Review progress every five years; and
- Provide climate finance to developing countries.

France will be the first country to introduce legislation in support of the climate agreement - all listed companies will be required to disclose their carbon footprint on an annual basis. Non-disclosure will incur penalties.

More countries will introduce mandatory carbon reporting in due course. Once governments receive accurate and periodic reporting, they may well call for the biggest emitters to reduce their carbon output.

The outcomes of conferences such as the COP21 are clear. Regulation specifically addressing climate change will seek to reduce carbon emissions into the atmosphere. As this movement continues to grow the price of carbon offsets will continue to rise. Companies will need to decide whether they invest in carbon-reducing technologies or continue to buy increasing costly carbon offsets. This cost will need to be factored into future risk models and is driving new innovative analyses on the impacts of carbon pricing (see Chapter 8).

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 includes the three pillars: E, S and G. These pillars are a lens through which to examine a company's operations, its manufacturing and services processes, 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	CEO/Chairman duality
Raw material sourcing	Heath and safety	Executive compensation
Supply chain management	Human rights	Shareholder rights
Waste and recycling	Product responsibility	Vision and strategy
Water management		Voting procedures

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

Examples of metrics could be:

Carbon emissions

- Total CO_2 and CO_2 equivalents emission in tonnes divided by net sales or revenue.

Product responsibility

- Has the company announced a mass recall of products or has it completely withdrawn a product owing to defects or safety issues?

Board structure

- Does the CEO simultaneously chair the board?

A pension fund will determine which ESG factors are important to its investments (we discuss this further in Chapter 5).

4.2 THE UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTING

The UN 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 standardised 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

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

The following 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 are material to investors.

4.4 THE UK STEWARDSHIP CODE

The Stewardship Code aims to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders. The Code adopts a 'comply or explain' approach. Pension funds can require their asset managers to comply with the Code or comparable international standards.

4.5 THE UK CORPORATE GOVERNANCE CODE

The Code sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders.

A STRATEGIC INITIATIVE FOR BUSINESSES THAT ARE COMMITTED TO ALIGNING THEIR OPERATIONS AND STRATEGIES

5 INTEGRATING ESG INTO THE INVESTMENT DECISION-MAKING PROCESS

5.1 INVESTMENT BELIEFS

MANY ESG PRACTITIONERS APPROACH ESG 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 UN PRI. As such, there is no one-size-fits-all set of beliefs.

While 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. Below we show the example of the Environment Agency Pension Fund.

Responsible investment beliefs of the Environment Agency Pension Fund

- Apply long-term thinking to deliver long-term sustainable returns;
- Seek sustainable returns from well governed and sustainable assets;
- Apply a robust approach to effective stewardship;
- RI is core in our skills, knowledge and advice;
- Seek to innovate, demonstrate and promote RI leadership and ESG best practice;
- Apply evidence-based decision-making in the implementation of RI;
- Achieve improvements in ESG through effective partnerships that have robust oversight;
- Share ideas and best practice to achieve wider and more valuable RI and ESG outcomes; and
- Be transparent and accountable in all we do and in those in which we invest.

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, eg 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, eg countries with weaker social welfare practices may require a greater focus on the ‘S’ than the ‘G’; and
- Key Performance Indicators (KPIs) that the pension fund might use to measure ESG performance, eg carbon emissions or governance scores.

A PENSION FUND WILL BE INFLUENCED BY ITS ORGANISATIONAL CULTURE

5.2 THE INVESTMENT PROCESS

INVESTMENT BELIEFS AND ESG POLICY

1 INVESTMENT OBJECTIVES	2 IMPLEMENTATION	3 MONITORING
Asset liability management (ALM)	Mandate design	ESG analytics
Asset allocations	Manager selection	Attribution
Statement of Investment Principles (SIP)	Risk appetite	Exposure analysis
	Portfolio construction	Risk analysis
	Benchmarks	Performance
	Stress testing	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 trustees to set the long-term objective(s) of the pension fund. This takes into account the pension fund's liabilities and current funding position, alongside longevity risk and liquidity requirements.

The trustees 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 RI 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,** eg What motivates you (the asset manager) to look at ESG issues (rationale behind responsible investing)?
- **ESG resources,** eg How are your portfolio managers incentivised to incorporate ESG factors?
- **ESG integration,** eg How are ESG factors incorporated into the investment analysis and decision-making processes?
- **Voting and engagement,** eg Do you have examples of engagement/where you have engaged a company and what you have achieved?
- **Monitoring,** eg 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, eg 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?); and
- Stress testing on ESG issues, eg 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 – is 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.

THE PENSION FUND SHOULD BE ENGAGING ASSET MANAGERS TO PROVIDE MORE DETAILED ESG REPORTS

6
ESG – DATA AND SCORING

6.1 THE IMPORTANCE OF DATA

ESG data provides pension funds with additional information to review risk and reward. Many of the data points collected for ESG risk assessments are not conventional risk measures and put companies under the microscope like never before, so it is important that the data used is accurate, is sourced independently of the company, and is analysed in the context of the financial risks that it might represent. This additional information will generate questions for the conversation with the asset manager.

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

A number of issues need to be considered:

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

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 vendors are able to acquire 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.

SAMPLE RESEARCH QUESTIONS

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 diversity in its workforce?
- The percentage of political donations made compared to total company revenue.

Governance

- Are the CEO and Chairman offices held by the same individual?
- Do the common equity shares of the company have equal voting rights on a per share basis?

Importantly, ESG scores need to be based on objective, consistent and compatible data points. Information should be collected and verified independently of the company to ensure the integrity and validity of the data. Therefore, in gathering ESG data, information should not always come directly from the company.

Answers are aggregated to generate a company ESG score. The example below shows A+ as the highest and D- as the lowest. However, a scale such as 1-10 could also be used (the principles remain the same).

A+ A A- B+ B B- C+ C C- D+ D D-

The ESG score can be analysed by its E, S and G elements. For example, a company with a total ESG score of B+ may have very high individual scores in both the Social and Governance categories, but a low Environmental score. This gives greater insight into the ESG risks associated with underlying investments.

6.3 ESG DATA PROVISION

ESG data vendors are developing new processes and databases. This is an important step in obtaining robust data so that ESG reporting and analyses 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.

Asset managers conduct their own research and company analyses and therefore have been incorporating elements of ESG research into their investment and stock selection process for many years. However, until recently, ESG reporting has not been separately requested by pension funds as part of the manager selection process nor embodied within the 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 at the individual company level do you have access to?
- 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); and
- Pension fund analysis (to understand risk by sector or by region).

1

ASSET LEVEL: Score each individual company asset

COMPANY /ASSET 1 A-
COMPANY /ASSET 2 B+
COMPANY /ASSET 3 B-
COMPANY /ASSET 4 A-
COMPANY /ASSET 5 B
COMPANY /ASSET 6 A-

2

PORTFOLIO LEVEL: Aggregate assets to score each portfolio

EQUITY PORTFOLIO B+
FIXED INCOME PORTFOLIO A-

3

PENSION FUND: Aggregate assets to create scores by sector, by region etc.

TOTAL PENSION FUND ASSETS A-

Sector	ESG score
Financials	A-
Cons Goods	B+
Healthcare	B-
Tech	C+
Utilities	B-

Region	ESG score
Euro ex UK	A-
UK	B+
Asia	C-
N. America	B+
Australia	A-

6.5 COMPANY ANALYSIS

Pension funds may want to see overall exposure to any one company, eg when analysing controversies.

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 fossil fuel stocks from its portfolio, it may wish to measure ESG performance against an index that has been optimised to exclude fossil fuel stocks.

6.5 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.

ESG reporting – sample portfolio report

BNP PARIBAS
SECURITIES SERVICES

SAMPLE PORTFOLIO vs. MSCI World
ESG Summary

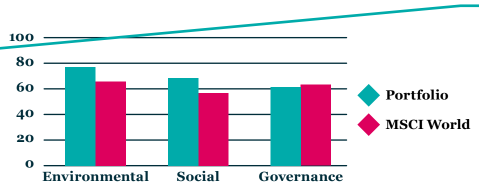
28/02/2015

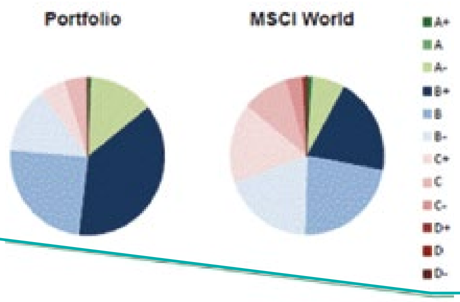
ESG SUMMARY

	Portfolio	MSCI World	Difference
Total Rating	**B+**	**B**	
Total Score	**69**	**62**	**11.7%**
Environmental	77.2	66.1	16.8%
Social	68.5	57.0	20.2%
Governance	61.6	62.5	-1.3%
Coverage	98.1%	97.8%	

BREAKDOWN BY ESG RATING (WEIGHT)

	Portfolio	MSCI World	Difference
High Quality			
A+	0.7%	1.1%	-0.4%
A	0.2%	0.1%	0.1%
A-	13.4%	6.8%	6.6%
Medium Quality			
B+	37.6%	19.9%	17.6%
B	24.4%	22.5%	1.9%
B-	13.6%	19%	-5.4%
Lower Quality			
C+	5.3%	16.5%	-11.2%
C	4.4%	9.7%	-5.3%
C-	0.5%	3.3%	-2.9%
D+	00%	1.1%	-1.1%
D	0.0%	0.0%	0.0%
D-			
Total	**100.0%**	**100.0%**	**0.0%**





THE PORTFOLIO OUTPERFORMED THE BENCHMARK:

- The portfolio has an ESG score of B+ (higher than the benchmark's B score)
- Outperformance is driven by the Environmental and Social pillars

GOOD COVERAGE FOR THE MSCI WORLD:

- 97.8% of the underlying companies in the portfolio are covered in the benchmark

THE PORTFOLIO IS UNDERWEIGHT ON LOWER SCORING ESG ASSETS:

- 10.2% of the portfolio in total is exposed to lower rated companies, vs. 30.6% for the MSCI World

7 ESG CHECKLIST

7.1 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 UN PRI)? ☐
- How will I aggregate data coming from multiple asset managers? ☐

8 CLIMATE CHANGE AND CARBON PRICING

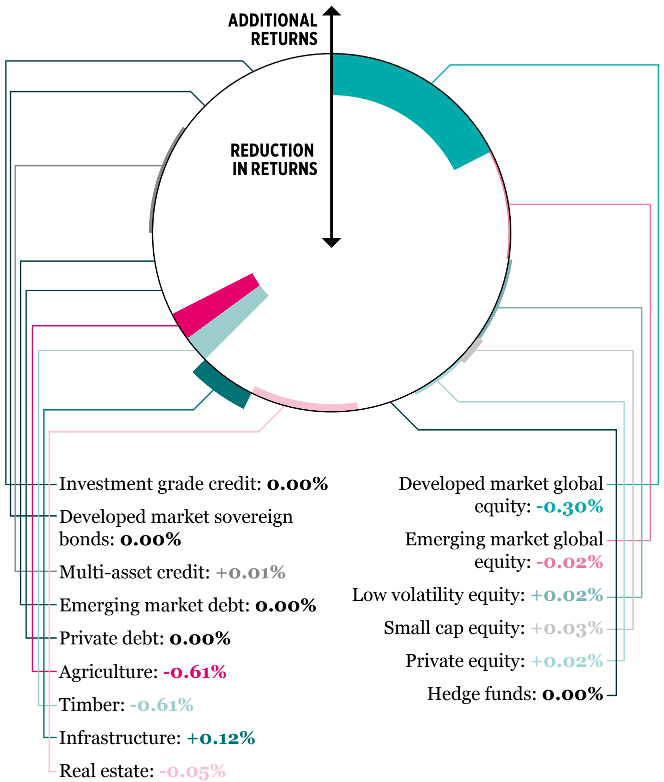
WHAT WILL A 2°C RISE IN THE EARTH'S TEMPERATURE MEAN TO A PENSION FUND'S INVESTMENTS? HOW ABOUT A 3°C OR 4°C RISE?

CLIMATE CHANGE HAS THE POTENTIAL TO DRAMATICALLY IMPACT INVESTMENTS AND THEREFORE AS AN ESG RISK IS SOMETHING THAT PENSION FUNDS NEED TO CONSIDER CAREFULLY.

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

8.1 THE CLIMATE CHANGE RISK TO ASSET CLASSES

A 2015 study by Mercer[5] modelled the impact on specific asset classes in various future global warming scenarios. The 2°C scenario for a model portfolio is represented below, highlighting the median impact over 10 years.



As this diagram shows, asset class impacts can be material.

8.2 CARBON PRICING

The Paris Agreement from COP21 produced a global climate change treaty under international law. The agreement states that global greenhouse gas emissions should peak 'as soon as possible' to keep the global temperature increase to 1.5 - 2°C above pre-industrial levels (the temperature recorded for 2015 reached a 0.9°C increase).

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. They also provide a yardstick that allows investors to assess whether regulatory change might pose performance risks for their equity portfolios.

BNP Paribas working with Avalerion Capital is developing a new approach to climate change stress-testing. Moving beyond assessing absolute carbon emissions, they are considering three policy factors and their impact on profit before tax (PBT). These three factors are:

- 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?
- If so, which of the three factors are 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?

5 Investing in a time of climate change

Initial results show that carbon price poses a material performance risk in four high-emission sectors:

- Utilities;
- Basic materials;
- Energy; and
- Industrials.

Analysis further 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 CO_2 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 the pension fund needs to also understand the risk posed by carbon pricing.

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

9 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 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 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-driven regulation will continue and will drive change which in turn will impact corporate and investment performance.

Service 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.

REGULATORS WILL NOT LIE IDLE

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