PRI RESPONSE

CANADIAN ASSOCIATION OF PENSION SUPERVISORY AUTHORITIES (CAPSA) GUIDELINE: ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS IN PENSION PLAN MANAGEMENT

14 October 2022

To inform this briefing, the following investor group has been consulted: PRI Global Policy Reference Group. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing.

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INTRODUCTION

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

ABOUT THIS CONSULTATION

In June 2022, CAPSA released the new Guideline: Environmental, Social and Governance (ESG) Considerations in Pension Plan Management for consultation with a view to gather stakeholder feedback on the document which focuses on ESG as an emerging pension issue. The PRI welcomes this opportunity to provide written comment with recommendations based on signatory views and evidence-based policy research.

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SUMMARY OF PRI RESPONSE

The PRI recognises the draft *Guideline: ESG Considerations in Pension Plan Management* as a necessary tool for Canadian pension plans and welcomes the opportunity to provide comment on the guideline's content. As fiduciaries, pension plan administrators have legal duties that require them to take into consideration any factors that are relevant to their legal purpose to provide a pension, and to act accordingly. Such relevant factors include any ESG factors, related risk and potential system-level sustainability impacts that could compromise the viability of the plan and undermine financial returns for plan members and beneficiaries.

Governments and regulators need to establish clear guidance for how pension plan administrators should consider sustainability factors in their investment decision making and stewardship processes, including how they should consider sustainability impacts. In the absence of such guidance and direction, inertia in market practice results in insufficient attention to sustainability factors, and pension plans and their asset managers may remain hesitant to use investment decisions, stewardship and policy engagement to pursue positive sustainability impacts – even when doing so may be in line with their duties to prioritise investment returns. It is therefore vital that CAPSA provide clarity on fiduciary duties to pension plan administrators across core pension management guidance.

The PRI determines that best practice guidance in plan governance should encourage administrators to define and publicly communicate the plan's investment beliefs and describe its approach, including how the fund considers ESG risk, sustainability-related investment opportunities and impacts that are relevant to the portfolio and to the success of the plan over time. The plan should demonstrate how such considerations frame its investment decision-making and stewardship activities.

Fund administrators should also be encouraged to publicly disclose any policies adopted to address ESG considerations, determine sustainability impact goals, assess sustainability performance and monitor progress towards established targets and objectives. The plan's Investment beliefs, investment strategy and approach should be reviewed regularly as understanding of sustainability impacts evolves.

KEY RECOMMENDATIONS

The PRI's key recommendations are the following:

- Incorporate **ESG risk across CAPSA's core pension management guidance** and enable a fluid cross-reference of the Governance, Prudent Investment Practices and Risk Management guidelines.

- Clarify the language and scope of "ESG factors/characteristics/information" to explicitly include **any sustainability factors, related risks and potential system-level sustainability risks that may have material relevance** to the financial risk-return profile of the pension fund's investments and to achieving the legal purpose of providing a pension to beneficiaries or members over the plan's time horizon.

- Define **"appropriate action"** to include the **pursuit of assessable improvements in sustainability impacts** in situations where doing so would reduce financial risk and improve returns over time, involving any combination of investment powers (asset allocation decisions) and stewardship powers (individual and/or collective stewardship activities and policy engagement).

- Contextualise **language on "ESG funds"** with a reference to the Chartered Financial Analysts (CFA) Institute's Global ESG Disclosures Standards for Investment Products and the Canadian Securities Administrators' (CSA) Staff Notice 81-334 – ESG-Related Investment Fund Disclosure.

- Ensure that **guidance** on plan governance **reflects the importance of ESG factors in relation to fiduciary duties**, and encourages the **incorporation of ESG risks, opportunities and relevant sustainability impacts into the investment beliefs** and in turn, in the plan's investment policies and strategy as reflected in, for example, the statement of investment policies and procedures (SIPP), risk management framework and other relevant policies.

- Define appropriate **public disclosure** to include communicating on how investment beliefs and investment policies address **ESG risks and impacts** and reporting on **progress made toward sustainability impact goals** or targets.

- Encourage **active and outcome-oriented stewardship across CAPSA pension management guidance** and update Guideline 6 to prioritise effective stewardship action targeting assessable, real economy impacts of an investee's business activities.

- Update Guideline 4 to clarify that Principle 1 on fiduciary duty **requires administrators to consider ESG impacts over time**.

DETAILED RESPONSE

All investment activity has consequences in the real world, positive or negative. Pursuing financial returns without considering the natural and social systems on which they depend may once have been viewed as common practice, but those days appear to be numbered. The World Economic Forum has identified inaction on system-level risks like climate change, human environmental damage, biodiversity loss, erosion of social cohesion and livelihood crises as some of the most severe global risks[1]. The financial and social cost of these real-world consequences is ultimately shouldered by taxpayers, savers and beneficiaries, communities, and governments.

[1] World Economic Forum (2022), The Global Risks Report 2022

Canadian institutional investors with long term investment horizons must acknowledge changing circumstances and act accordingly to ensure they adequately discharge their fiduciary duties. To maintain and improve long-term financial performance in the best interests of clients and beneficiaries, long term investors are called upon to reimagine their role as responsible stewards of capital and generators of sustainable long-term value within social and planetary boundaries.

That is why the PRI, the United Nations Environment Programme Finance Initiative and the Generation Foundation commissioned the report called, A Legal Framework for Impact (LFI), which examines the extent to which legal frameworks support investors' efforts to do so. The report, authored by Freshfields Bruckhaus Deringer, finds that in the 11 jurisdictions analysed, including Canada, investors are broadly permitted to consider pursuing sustainability impact goals where this would contribute to their financial return objectives.

Specific to Canada's legal framework, the report finds that **investors are permitted and may even be required to consider pursuing appropriate positive sustainability impact goals as a means to ensure financial returns and protect financial value** – for example, in order to mitigate system-level risks such as climate change. Wider societal objectives should also be taken into consideration where they are relevant to the fund administrators stated financial goals and to their legal duties, which require them to act prudently in line with their primary purpose of providing a pension to beneficiaries.

COHERENT MESSAGING ACROSS CORE PENSION MANAGEMENT GUIDANCE

As the consideration of ESG risk is consistent with fiduciary duties in Canada, ESG risk should be incorporated across CAPSA's core pension management guidance to enable a fluid cross-reference of the Governance, Prudent Investment Practices and Risk Management guidelines.

DEFINITION OF ESG FACTORS

For clarity, the PRI recommends that the Guideline define relevant ESG factors to explicitly include any sustainability factors, related risks and potential sustainability impacts that may have material relevance to the financial risk-return profile of the pension plan's investments over the plan's time horizon and to the purpose of providing a pension to beneficiaries or members. The definition for ESG factors should be used consistently throughout CAPSA guidance documents and the definition should be included in the FAQ.

It is becoming more common in discussions about the role of sustainability factors in investment decision-making to assess whether they are "financial" or "non-financial". Deciding whether a particular sustainability factor is financial or not is not always easy, and the financial relevance of at least some sustainability factors is not universally understood. For example, a factor that has traditionally been seen as non-financial may have an impact on an investee company's reputation, business model or governance and thus its value – and therefore could be considered a financial factor. In fact, the key question for an investor is whether a given factor has a bearing on its investment objectives, defined in accordance with applicable law and which are likely to be financial but may also include other objectives. From that perspective, the issue is not simply whether the factor itself is "financial" but whether it is relevant to achieving the investment objectives. **Sustainability factors should be considered based on its relevance to the investor's proper purpose and objectives.[2]**

FIDUCIARY DUTIES AND APPROPRIATE ACTION

In the sections of the Guideline addressing what fiduciary duty means in the context of ESG, the Guideline should define "appropriate action" to include the pursuit of assessable improvements in sustainability impacts, where doing so can reduce financial risk and/or improve returns over time and so contribute to the investment purpose to provide a pension to beneficiaries or members.

Appropriate action may involve the intentional use of any combination of investment powers, individual and collective stewardship activities and policy engagement, to mitigate sustainability risks or to pursue improvements in sustainability impacts where doing so can help improve financial returns. For example, such action may be taken to help reduce portfolio exposure to system-level risks – sometimes referred to as "better beta" – thereby potentially improving financial outcomes over the long term.[3]

As diversification, a core tenet of the popular modern portfolio theory, does not address system-level risks to investors' portfolios, investors can focus rather on stewardship and engagement with policy makers, acting individually or in collaboration with other investors.

Many investors are already taking such approaches. One example is more ambitious stewardship driven by sustainability concerns: as highlighted in the Legal Framework for Impact Report,[4] the investor-led Climate Action 100+ initiative[5] is increasing focusing on the outcomes of companies' decarbonisation commitments, and a number of its investor members are setting emission reduction targets for their investee companies. A similar domestic initiative, Climate Engagement Canada, has recently been launched to promote a just transition to a net zero economy by focusing on the 40 top emitting TSX listed companies not currently targeted by CA 100+ engagements.[6] Those investors that are doing so in order to address the financial threats arising from climate change are engaging in *instrumental investing for sustainability impact.*

[2] An investor's objectives are narrower than purpose and, unlike purpose, may change over time.
[3] Hawley, J., Lukomnik, J. (2019) Modernising modern portfolio theory
[4] Freshfields Bruckhaus Deringer, PRI, United Nations Environment Program Finance Initiative, Generation Foundation (2021), A Legal Framework for Impact: Sustainability Impact in investor decision-making (p.38)
[5] Climate Action 100+ currently has 700 investors and 166 companies as members
[6] See Climate Engagement Canada

"ESG FUNDS"

The reference to "ESG funds" in Sections 2.1 and 4 could be misleading as there is currently no global consensus on a definition. Without consistent, comparable and comprehensive ESG information, investors' understanding of their investments is inherently limited. The CSA has attempted to address the issue of greenwashing by publishing guidance in the form of the Staff Notice 81-334 – ESG-Related Investment Fund Disclosure, while the Securities and Exchange Commission has proposed recent binding rules.[7] The Chartered Financial Analyst (CFA) Institute has created the Global ESG Disclosures Standards for Investment Products to provide greater transparency and consistency in ESG related disclosures, to enhance clarity with respect to the ESG-related features of investment products. These documents could be used as a reference to provide pension fund administrators with context until the day that corporate issuers begin to report against the ISSB's standards.

BEST PRACTICE

Governance

The Guideline should encourage best practice in plan governance by advising administrators to consider the importance of ESG risks, opportunities and system-level sustainability impacts to the fund's purpose and financial objectives over time and incorporate them in the fund's investment beliefs, providing a solid foundation for the fund's investment strategy and approach.[8] The investment beliefs, strategy and approach should be revisited every 2 to 5 years.[9]

Disclosure

Transparency builds confidence. A recent PRI report on investment related ESG reporting requirements concludes that jurisdictions where the consideration of ESG issues is generally accepted as part of investment decision-making and consistent with fiduciary duty, ESG reporting is mandatory and reporting requirements are more extensive. Canada is considered a "low regulation jurisdiction" along with the United States.[10]

Specific to climate risk, Canadian pension regulators should phase in mandatory reporting on the Task Force on Climate-related Financial Disclosures (**TCFD**) recommendations and ISSB climate standards, starting with large pension funds (i.e. funds with greater than $5 CAD billion net assets).

More generally, best practice should encourage an appropriate level of public disclosure, starting with the investment beliefs, strategy and approach of the fund, followed by what policies have been adopted to address the ESG considerations, sustainability impact goals or targets adopted to affect change. Fund administrators are encouraged to report annually on actions taken through stewardship and policy engagement activities to mitigate risks and meet long term financial obligations, demonstrating progress made against targets.

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[7] See PRI's responses to SEC file S7-16-22: Investment Company Names and SEC file S7-17-22: Enhanced Disclosures by Certain Investment Companies About ESG Investment Practices
[8] See PRI's guidance on Crafting an Investment Strategy
[9] PRI (2018) Asset Owner Strategy Guide: How to Craft an Investment Strategy (p. 11)
[10] PRI (2021) Review of Trends in ESG Reporting Requirements for Investors (p. 10)

Stewardship

Addressing system-level risks and achieving positive sustainable outcomes in support of financial objectives and the wider best interests of beneficiaries, and society, should be a priority for responsible investors including pension funds and necessitates a whole of industry response.[11] This requires enhanced collaboration between institutional investors, particularly in relation to investment stewardship. Not only is collective action through investee engagement an effective way to effect positive change, but it also spreads the costs of addressing collective goals across the industry and enables all institutional investors to reap the benefits.[12]

To encourage active and outcome-oriented stewardship, the PRI recommends that CAPSA update [Guideline 6] to prioritise the effectiveness, effort and efficiency of investor action.[13]

Beneficiary best interest

To provide consistent messaging across core pension management guidance, the PRI recommends updating Principle 1 on fiduciary duty in the [Guideline 4] to clarify that administrators are required to consider ESG impacts over time.

CAPSA should help guide pension schemes on assessing whether achieving broader societal and environmental goals may improve the quality of life for members and beneficiaries into retirement, and if so, how these goals may be relevant to their best interests and hence to the scheme's purpose. In such cases, the broader goals identified would be relevant to a pension plan's investment beliefs, policies and procedures. This should be balanced with the need for pension plan administrators to consider all relevant issues. Responsibility for the investment of pension funds rests ultimately with the plan's administrators.

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[11] Freshfield Bruckhaus Deringer, the Principles for Responsible Investment, UNEP FI, the Generation Foundation. (2021). A legal framework for impact. https://www.unpri.org/download?ac=13902.
[12] PRI. (2019). *Active ownership 2.0: The evolution stewardship urgently needs*. https://www.unpri.org/download?ac=9721
[13] See PRI's response to SEC file S7-17-22: Enhanced Disclosures by Certain Investment Companies About ESG Investment Practices (p. 21)