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As intergenerational stewards of capital, pension funds can have many good reasons to embrace environmental, social, and governance (ESG) issues in their investment practices. Yet the particular structure of pension funds creates both advantages and disadvantages for the integration of ESG. This paper reviews the historical origins, regulatory mandates, and fund structures of pensions, to tease out exactly which of these characteristics enable and which of them impede the inclusion of ESG at pension funds. We use the case of PSP Investments to lend depth to the application of the strategies that emerge in the pensions industry.

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On November 23rd, 2020, the CEOs of the eight largest Canadian pension funds—the so-called 'Maple 8'—made a public pledge about their commitment to 'creating more sustainable and inclusive growth by integrating environmental, social and governance (ESG) factors into our strategies and investment decisions.' Arguing that this was not only the correct thing to do, they also stated that [this] 'is an integral part of our duty to contributors and beneficiaries [which] will unlock opportunities […and] deliver long-term risk-adjusted returns' (PSP 2020: 1). A similar open letter was issued only six months earlier, in March 2020, by the then-leaders of three of the world's largest pension funds: the California State Teachers' Retirement System (CalSTRS), the Japanese Government Pension Investment Fund (GPIF), and the largest UK pension fund, the Universities Superannuation Scheme (USS). Here, the three giants outlined that 'if we were to focus purely on the short-term returns, we would be ignoring potentially catastrophic systemic risks to our portfolio' and underlined how 'asset managers that only focus on short-term, explicitly financial measures, and ignore longer-term sustainability-related risks and opportunities are not attractive partners for us' (GPIF 2020: 1).

These statements tell us that pension funds can have many good reasons to embrace a sustainability lens in their investment practice, and that they are increasingly—and publicly—willing to do so. A main driver of the move to embrace ESG in pensions is the inherent need for long-term managers of corporate risks and opportunities to live up to their responsibilities as intergenerational stewards of capital. Nevertheless, the particular structure of pension funds creates both advantages and disadvantages for the adoption of sustainable finance practices and the integration of ESG. While asset owners are often hailed as the ultimate enablers of a sustainable transition on the financial market,[1] in many instances, pension funds do not live up to this expectation. In particular, pension managers must consider how to include ESG given their primary mandate and fiduciary duty to secure long-term financial returns for their beneficiaries. Accordingly, pension managers seeking to integrate ESG must operate within a web of pension regulation, the legal interpretation of fiduciary duty, and the organizational characteristics of pensions.

To analyze these institutional and organizational enablers and inhibiters of ESG integration at pension funds, we employ the notion of 'social origins' (Eccles and Stroehle 2018; Eccles et al. 2019) in our review the historical and structural characteristics of the pension sector. Social origins are defined as a combination of the historical and organizational origins of actors that condition the social construction and use of often-vague concepts, such as ESG, within them. In our analysis, we mostly focus on large public and private sector pension funds. By drawing on existing literature and primary interview data, we seek to identify the characteristics and capabilities of these funds that help or impede them in contributing to a larger sustainability agenda within their mandate. To do so, we focus on three levels of analysis: *the institutional level,* which discusses historical and regulatory embedded within the interpretation of fiduciary duty; *the organizational level,* which reviews how investment mandates are translated into policies, governance structures, and collaborations; and *the portfolio level,* which reviews investment strategies and asset allocation, relationships with asset managers and pension funds' stewardship activities. While drawing on the larger literature about sustainability in pension funds, we focus our review on the pension systems in Canada, the US and the UK. An in-depth case study of the Canadian Public Sector Pension Investment Board ('PSP Investments' or 'PSP') supplements this structural comparison with more detailed and practical insights.

Ultimately, our question is: what is it that makes these funds so well-positioned to drive a wider integration of ESG, and why is this potential only partly being realized to date? Accordingly, our research seeks to draw attention to both the potential that pension funds have in disseminating good practice in the wider investment community, and the inhibiting factors relevant to this system.

Pensions in the 21st Century

A growing body of literature discusses how and why ESG is a potentially important source of information for the investment decisions made by pension funds. Much of this debate frames ESG as a tool that to help address the growing risks that have arisen globally, such as climate change and income inequality, alongside the realization that sustainability-related system-level challenges can and will have a material impact on market financial stability. The integration of ESG factors in investment decision-making is then meant to hedge against this risk, while at the same time being potentially able to identify companies with a higher growth and performance potential (Bender et al. 2018).

To verify this, studies have reviewed the use of ESG in pensions' asset allocation strategies (Hawley and Lukomnik 2018; Alda 2019), their fiduciary duty and responsibility towards beneficiaries (Bird and Gray 2013; Hoepner et al. 2011; Ambachtsheer and Bauer 2013), their different schemes (Hoepner et al. 2011), and their investment horizons (Ambachtsheer 2014; Kecskés et al. 2020). Since many pension funds manage their assets at least in part externally, there is also a growing interest in how ESG features in pension funds' mandates to their asset managers (ICGN 2012). Furthermore, pensions' relationship with sustainability is also considered in broader debates such as the universal ownership thesis (Quigley 2019a 2019b; Urwin 2011; Monks and Minow 2004), moral relativism (Eabrasu 2018), collective action (Gond and Piani

2013; Woods 2011), the politicization of investors (Clark and Monk 2011) and in debates around the tragedy of the commons (Kiernan 2007).

In parallel to the increasing importance of ESG, two important structural developments have influenced the pension industry. Firstly, the size of pension funds has grown significantly since the 1990s, correspondingly expanding the influence these funds have on the larger economy (Johnson and De Graaf 2009). Secondly, many funds are transitioning from defined benefit (DB) to defined contribution (DC) plans (Fabian et al. 2021). Both developments have important implications for a potential integration of ESG.

The size of pension funds. According to a study of the Thinking Ahead Institute in 2020,[2] the value of assets under management at the pension funds of the 22 major retirement countries were on average equivalent to 62 percent of the GDP of their home countries. In Canada, the UK, and the US, these numbers are even higher, with 90.5 percent, 108.7 percent and 85.8 percent respectively in 2019,[3] highlighting just how important pension saving is in these markets. Globally, pension funds are worth just over $50 trillion USD. In terms of equity holdings, pension funds in the US held shares representing approximately 21 percent of the US equity market and 11 percent of global equities. Canadian and UK pension funds held shares equivalent to approximately 19 percent and 8 percent of their national equity markets value.[4]

Due to their size, pension funds have an important and expanding influence on the capital markets (Johnson and de Graaf 2009), and are often described as the archetype of universal ownership. This is particularly true for large public sector funds (Fabian et al. 2021). Universal owners are commonly defined as large diversified institutional investors who have a long-term investment horizon (Quigley 2019a). In the ESG debate, the notion postulates that these institutions must take into account externalities, both across their (usually global) geographical portfolios, and in accordance with intergenerational equity (Urwin 2011). In line with this, Clark and Monk note that pension funds, ‘by reason of their size, hold such significant stakes in the market for traded securities that portfolio diversification is not an adequate means of risk management’ (2010: 1731). Academics have therefore suggested that pensions take a systems-level approach in investing (Hawley and Lukomnik 2018), to use their size for influence through active (even activist) stewardship of companies (Quigley 2019b), and to make use of their collective power in lobbying for change, both through the investment chain and at the policy level (Gond and Piani 2013).

Transition from DB to DC. Over the last 30 years, a large majority of pension funds has shifted away from the traditional DB model, which provided benefits based on workers’ salaries and lengths of service, toward DC plans, where contributions are made to investment accounts and funds are paid as benefits upon retirement (Fabian et al. 2021; Thurley and McInnes 2021). While this shift has been more marked in the private, compared to the public, sector, the trend is likely inexorable. This leads to concerns around the possibility of integrating ESG into retirement systems, as most DC plans do not offer a sustainability fund. In the US, for example, only 2.8 percent of 401(k) plans in the US offered an ESG fund on their menus as of 2018 (Plan Sponsor Council of America 2018). This is likely due to concerns about fiduciary duty and conflicting regulatory policy, both of which led to confusion about the legality of pension products incorporating ESG (Fabian et al. 2021). Since in practice, most plan participants tend to stick with the fund into which they are defaulted when they join a plan, investment, the creation of an ESG default option could be a useful place to start (The Pensions Regulator 2021). To date, however, ESG default options are largely non-existent in DC plans.

ESG Strategies and Outcomes at Pension Funds

When reviewing ESG strategies and outcomes, one needs to keep in mind that the ESG concept and the underlying data are used in different ways. For instance, many believe that the inclusion of ESG in investment decisions is critical for pension funds' long-term risk management and financial sustainability, yet there is no unique pathway by which this can be accomplished. For instance, plans may distinguish between risk-focused use of ESG, financial value-seeking ESG strategies, strategies based on normative principles, and those seeking positive social impact (Eccles and Stroehle 2018; Giese et al. 2019). Many investors will use a combination of these approaches; for instance, some could exclude morally sensitive sectors while at the same time elect a long-term value-seeking strategy through ESG integration. Figure 1 provides an overview of the range of choices that investors may confront when seeking to include ESG in their investment decision making.

Figure 1 here

Because these strategies have fundamentally different motivations, their logic can be contradictory. For example, exclusion is under heavy debate, because it has been proven to have financial downsides (Atta-Darkua et al. 2020); at the same time, there is no real proof for its effectiveness in pushing firms to act in a more sustainable manner (Kölbel et al. 2020). ESG integration, on the other hand, seeks a financial upside—an objective that can be complemented with a simultaneous exclusion strategy. Due to this, there is an increasing call to embrace stewardship and engagement, instead of exclusion as a strategy. Engagement is argued to be a more effective tool for creating behavioral changes at companies, therefore inducing both a positive impact on the world and creating a financial upside (Broccardo et al. 2020; Blitz and Swinkels 2020).

Pension Origins and Key Characteristics for ESG Integration

Based on our literature review, numerous expert interviews we conducted (see the appendix), and case studies, we next discuss pension fund characteristics which appear to be particularly important for the adoption of ESG practices. The three levels on which we focus include the *institutional, organizational* and *portfolio levels*. Figure 2 summarizes the elements discussed.

Figure 2 here

The institutional level sets the legal boundaries to a pension fund's ability to integrate ESG. This ability stems from the historical origins of pension funds, their regulatory embeddedness, and the interpretation of fiduciary duty by the regulator. Historically, pension funds have been heavily influenced by social and political developments in their respective home countries, resulting in a diverse landscape of national pension systems around the world (Hammond and O'Brien 2021). The first pension system leads back to the German Empire in the late 19th Century, where Chancellor Otto von Bismarck passed the Old Age and Disability Insurance Bill in 1889. In the UK, the Old Age Pensions Act of 1908 was the first piece of legislation which awarded pensioners age 70 or above a basic allowance (Filgueira and Manzi 2017). The motivation of these early pension systems was driven by the Industrial Revolution and the growing importance of the working classes, which required governments to alleviate old-age poverty in light of rising life expectancies and failing familial support structures (Filgueira and Manzi 2017).

Much of today's debates around the structure and purpose of pensions, however, have their origins in the 1990s, when there was mounting uncertainty about the financial sustainability of the 'Pay-As-You-Go' public pension system in many of the OECD markets. As life expectancy rose and seniors comprised a greater share of the population, this triggered a debate about the funding of the pension plans as well as the move from DB to DC plans (Thurley and McInnes 2021). Eduard van Gelderen, Senior Vice President and Chief Investment Officer at PSP, described the shift in thinking related to this, saying that: ‘there was a growing realization that pension capitalism was actually social capitalism, […] and so early questions about stewardship and governance became questions about how to create a better world for pension plan members.’

Despite such shifts in thinking, integration of ESG-related considerations into pensions fund management has made slow progress, encouraged by several national and international developments. The 2008 financial crisis, for example, gave rise to concerns about the stability of the financial market. In addition, platforms such as the United Nations (UN) Global Compact in 2000 and the UN Principles of Responsible Investing (PRI) in 2006 generated new pressure encouraging ESG considerations. In some jurisdictions, increasing stakeholder pressure also played a crucial role. In the UK, for example, several social movements accelerated the conversation around ESG in the late 1990s, where organizations such as Ethics for USS[5] specifically targeted pension funds to include environmental and social considerations into their investment decisions. As a response, USS adopted a sustainable investment policy in 1999.

Due to different historical experiences, pension regulation has evolved very differently in the three markets studied. In the US, the Employee Retirement Investment Security Act (ERISA) is cited as a challenge for pension funds seeking to integrate ESG factors, particularly in DC plans, as it gives little to no guidance on how this can be done (Fabian et al. 2021). To address this, a bill to amend ERISA was introduced by the Democrats in the Senate and House in May 2021, seeking to require that plans would have to consider ESG factors in a prudent manner consistent with their fiduciary duties (US Senate 2021). In the UK, the 2006 UK Corporate Governance Code and the

2021 UK Stewardship Code underscored the linkage of fiduciary duty and ESG as long-term risk factors. Additionally, since 2019, legislative measures from the UK Financial Conduct Authority (FCA) require pension trustees to set out in their investment policies how they include ESG considerations in investment decisions (Webb and Brown 2019). Finally, in Canada, according to Section 78(3) of the Ontario Pension Benefits Act, Province of Ontario-governed pension plans are required since 2016 to state 'whether environmental, social, and governance (ESG) factors are incorporated into the plan's investment policies and procedures, and if so, how they have been incorporated.' As of now, only Ontario-governed pension plans and a few public sector pension plans have equivalent obligations. The Canadian regulatory authorities have not yet adopted the equivalent of a Canadian Stewardship Code for investment fiduciaries, but the Canadian Coalition for Good Governance,[6] an important voice on governance matters in Canada, published in 2017 seven stewardship principles which align with similar codes or principles in other countries, while reflecting on the unique nature of Canada's capital markets. These principles, supported by many large institutional investors, were intended to help institutions investing in Canadian public equities be active and effective stewards of their investments

How pension plans can and want to consider ESG in investment decisions is highly dependent on the interpretation of fiduciary duty, both by the regulator and by the financial institution itself, a conclusion which regulates the relationship of a fund with its key stakeholders (Clark 2004; Clark and Monk 2011). Because pensions have a delegated authority to watch over their beneficiaries' retirement income with an intergenerational mandate, their fiduciary duty and legal constraints differ from other institutional investors. Yet while the concept of pension manager fiduciary duty is grounded in a relatively stable set of legal principles, the interpretation of fiduciary principles can be quite dynamic, evolving with 'societal expectations' in the past (Wood

2011). Recently, for example, the Canadian Business Corporations Act (CBCA)-Section 122 (1.1) was amended to codify the longstanding common law principle that directors and officers of CBCA corporations are not required to consider only the interests of shareholders when acting in the best interest of the corporation. Instead, they may also consider, among other factors, the interests of employees, the environment, and the long-term interests of the corporation. Hawley et al. (2011) stresses the need to rethink the concept of fiduciary duty.

To more closely link intergenerational timeframes of pension fund mandates with the interpretation of fiduciary duty, some contend that ‘pension sector leaders should have a legal obligation to look beyond tomorrow, and to focus the capital at their disposal at the long term’ (Ambachtsheer 2014: 9). Richardson and Peihani add that this can ‘create leverage to require trustees to be considerate of the needs of future pension plan retirees, decades from now, who may be impacted by changing economic and environmental conditions’ (2015: 450). Yet where an expanded legal definition of fiduciary duty already exists, as is true for some, not all, types of pensions in common-law countries, implementation is usually unmonitored and unaudited, often without impact on investment decisions (Quigley 2019a).

The organizational level of pension funds is embedded in and shaped by the regulatory environment, as described above. Ultimately, the regulatory environment decides on the level of ambition that a pension fund can have when integrating ESG. We find that the regulatory environment of pensions is not always a supporting factor for the integration of ESG, and that pensions confront strict and narrow mandates, which often make it difficult for them to incorporate factors other than those of a financial nature. Leadership and corporate governance, the investment policy of a fund, and fund manager willingness to advocate and collaborate are therefore key factors at the organizational level that determine a pension fund's ability to incorporate ESG into investment decisions. The following section discusses this in more detail.

Corporate governance and leadership. Within the given mandate and legal structure of a pension fund, the corporate governance of a plan and its leadership can be vital catalysts for the adoption of sustainable investment strategies. While some legal mandates give pension boards and leadership very strict boundaries where they cannot purse ESG policies, others give them more freedom and/or impose certain responsibilities. Where the legal environment gives no clear guidance, proactive leadership from pension boards and executives can push and enable a sustainable investment agenda and strategy. In other instances, as in the UK, pension trustees cannot legally provide opinions or advice on a fund's investment strategy. Still, their guidance and standpoint on long-term risk and sustainable development can help catalyze the right decision within a fund.

At an organizational level, pension funds still face the inherent challenge of having a long-term commitment towards their members, while facing public and sponsor expectations of generating short-term returns. This tension requires a thoughtful investment policy, strategy, and a clear interpretation of fiduciary duty at the organizational level.

Investment policy. Pension funds are increasingly publishing investment policies referring to ESG as one of many material factors. While this is mandatory in jurisdictions like the UK, this practice is also found in the US and Canadian pension markets. The Global Stewardship Principles from the International Corporate Governance Network (ICGN 2016) and guidance from the UN PRI (PRI 2021) have clearly made it easier for firms to issue statements of investment policies and beliefs. While there are concerns about greenwashing and 'box-ticking' in instances of mandatory inclusion of ESG in policies (Webb and Brown 2019), these documents can provide a good opportunity for boards and/or trustees to demonstrate that they are taking ESG risks and opportunities seriously.

According to the PRI, 'responsible investment can be integrated into investment policies in many ways, including high-level public statements, codes of business practice, a standalone responsible investment policy or by embedding responsible investment considerations into an organization's main investment policy' (2021: 2). A sustainable investing policy or strategy therefore need not start with an ambitious zero-carbon commitment, but instead it can start with simply signaling awareness and willingness to being a responsible steward of capital. In this way, ESG is becoming increasingly relevant for the purposeful use of voting rights, influencing company strategy to ensure that pay is aligned, that there is quality disclosure (e.g., by supporting standard-setting), and that advocating for legislation enables long-term investing. The importance of policies also ties to our previous discussion of definitions of success regarding the use of ESG in investment decisions. Ideally, an organization's responsible investment policy defines what this success looks like within a given legal structure.

Collaboration and Advocacy. The notion of investor stewardship, as outlined for example by the ICGN, highlights the importance of investor collaboration to enhance the outcome of stewardship activities, such as engagement with companies (ICGN 2016). The decision as to whether a pension fund is willing to collaborate with other institutional investors and, indeed, whether it will advocate for sustainability topics through lobbying or endorsement activities, must be made at an organizational level and depend on the openness and interest of a fund's leadership in ESG.

Indeed, pension funds are no stranger to collaborations with other market participants. Via global forums such as the Net Zero Asset Owner Alliance, to more local groups such as the Maple 8, pension funds can increasingly communicate, share best practices, and collaborate with their.

Yet due to their limited resources, not every pension fund can get involved in every collaboration or lobby for every relevant piece of legislation. Nevertheless, carefully chosen collaboration can actually increase efficiency, and well-placed advocacy can have spillovers.

On the advocacy side, public sector pension funds can collaborate with policy makers as well. The Maple 8, for example, met with the Canadian security regulators to engage on proxy voting. Furthermore, pension funds may support frameworks or organizations that they see as useful for advancing sustainable finance practices on a global level. CalPERS, for example, has taken a public stand to support various initiatives of sustainability disclosure standardization such as the IFRS consultation and the consultation on the foundation of the Value Reporting Foundation (CalPERS 2020). In 2021, as another example, ten Canadian pension funds recently offered public comments on the SEC Climate Change Disclosure Consultation (SEC 2021).

The portfolio level. Under the assumption that interpretation and guidance from board and leadership allow for considerations of sustainable finance, we next turn to several factors important for ESG integration at the portfolio level.

<u>Investment strategy and asset mix.</u> Pension funds are usually highly diversified funds that invest in public market bonds and equities, and increasingly, they make substantial allocations to private equity, real estate, and infrastructure investments. A 2020 study from Mercer showed that, on average, European pension funds had invested 22 percent in public equity, 47 percent in growth fixed income, 53 percent in real assets, and 14 percent in private equity. The same survey found that in 2020, 88 percent of these funds had considered integrating ESG into their investment policy, up 20 percent from the year before. ESG integration in multiple asset classes is therefore a current challenge for pension funds and their managers.

ESG integration in investment has its origins in the public equity markets (Eccles and Stroehle 2019), yet these discussions have increasingly become relevant in the fixed income and private equity markets as well (Schroders 2020). Integrating ESG considerations into these different asset classes, however, requires different approaches and a deep understanding of how each of these markets work. For example, the need to move with agility varies by investment. In public markets, for instance, investments tend to be liquid and stewardship tools, such as voting and engagement, permit investors to try to influence a company's direction (at least to some extent). Investors in public companies can generally react by selling their stock if, for example, concerns about long-term value or sustainability risks emerge. Of course this is only true if the stock is not held in an index or index replication strategy.

In private markets, by contrast, and particularly in private equity, investments tend to be less liquid. Accordingly, pension funds must carefully assess the risk and long-term strategy of each holding. ESG considerations in private investments can therefore be useful when assessing private assets and the need for continuous stewardship. Moreover, many investors have traditionally held private equity for their high financial returns, with ESG not being a priority, but this is starting to change significantly (Zaccone and Pedrini 2020). Additionally, General Partners managing private equity funds are gradually integrating ESG into their investment and asset management decision-making; some have even launched 'impact funds,' which focus specifically on the creation of positive social impact, though these are still niche products.

In fixed income investments, ESG can inform a negative or positive screening of the investment universe, or flow into the fundamental analysis of an issuer. In this regard, ESG integration into fixed income can resemble the public equity side. Nevertheless, ESG in fixed income is meant to inform about a potential credit risk. Accordingly, the issues important for a fixed income analyst may be very different that those that are important to shareholders (CFA 2019). So while an investor may choose to divest from a company on the public equity side (for example, due to an ESG scandal), there may be incentives to simultaneously buy the bonds of the very same company. This highlights how tradeoffs between financial and ESG considerations are structured differently in different asset classes.

Relationships with Asset Managers. Pension funds have the choice either to manage their assets in-house, or to hire asset managers to manage their assets externally. Either way, the balance is struck between cost and return, where the higher cost of an outside manager is anticipated to be offset by a higher expected investment return. Most recently, the trend towards external managers has stalled. In the US, for example, larger state and public pension funds have returned to managing at least part of their assets in-house (Aubry and Wandrei 2020), often driven by concerns about the fees of these managers and related after-fee returns. If assets are internally managed, the pension fund can, within its mandate, have full discretion over ESG integration. When assets are externally managed, the UN Principles of Responsible Investment (PRI) suggest that pension funds integrate their sustainable investment priorities into manager selection, appointment, and monitoring (PRI 2013).

The choice of internal versus external management in different asset classes will impact how much direct influence a pension fund can have over how ESG is integrated into investment decisions. Pension funds can outsource everything from portfolio construction, investment decisions, to engagement with holding companies and proxy voting. The selection of an asset manager for these activities is therefore important from an ESG perspective. An early alignment on ESG priorities and expectations about transparency, reporting engagement and, when applicable, voting, are key to ensuring that ESG is taken into consideration in a way that fits with the pension fund's investment policy. ESG factors can then also be integrated into the asset manager monitoring process, which catalyzes ongoing conversations and reviews. Furthermore, while pension funds are explicit long-term owners and increasingly formulate expectations for long-term risk management, including ESG, their mandates to and reviews of asset managers can in fact be quite short term. Accordingly, longer-term mandates and performance reviews are needed to enable external managers to effectively manage the ESG priorities of their clients.

Finally, in private equity, pension funds can sometimes have only a limited effect on their managers. Currently private equity funds are often oversubscribed, so General Partners (GPs) can often pick and choose the clients with whom they wish to work. This inhibits ESG conversations, as it reduces the ability of Limited Partners (LPs) such as the pensions buying into a private equity fund to negotiate disclosure requirements around new practices such as ESG. To this end, the International Limited Partner Association represents one forum where a coordinated pension fund voice can help establish a process for the whole private equity industry. If every pension fund were to require the same standard disclosure from GPs, it could very likely be a 'game changer,' much more so than sporadic and uncoordinated LP requests. Additional groups such as the UK Pension Coalition for Inclusive Capitalism and the International Corporate Governance Network have called for standard contract formats for public external managers.

Stewardship activities. Finally, pension funds can use active ownership and engagement activities to exert their influence and to maximize both financial and ESG value. Stewardship and ESG integration can be linked and complementary activities integral to responsible investing (PRI 2021). According to the ICGN, stewardship is 'the responsible management of something entrusted to one's care. This suggests a fiduciary duty of care on the part of those agents (…) acting on behalf of beneficiaries, who are often long-term savers or members of pension funds' (ICGN

2016: 4). Stewardship is meant to promote high standards of corporate governance, to preserve and enhance long-term value, and to enhance systemic market stability.

Engagement—which is one tool used for stewardship—can enhance investment decisions, communicate concerns, and foster relationships and constructive conversations with companies about their ESG strategies. Eccles et al. (2021) outlined several strategies of engagement to be used for ESG interactions with issuers and holdings. Some are top-down, including conservative and opportunist engagements. Here ESG scores and topical lenses are used to screen the entire portfolio and engage laggards and leaders. Bottom-up strategies focus more on long-term, constructivist interactions that build relationships between the pension fund and companies. Alternatively, activist strategies can be used to address topics perceived as critical and neglected (Eccles et al 2021). Overall, stewardship and engagement allow pensions to take ESG positions and actions.

A Case Study: PSP Investments

To add depth to our analysis, we undertook an in-depth case study of PSP Investments in Canada, analyzing just how the fund's historical origins and organizational characteristics link to its understanding of ESG and its responsible investment strategy. PSP Investments is one of Canada's largest pension investment managers: it is a Canadian Crown corporation that invests DB pension plan assets for the federal public service, the Canadian Forces, the Royal Canadian Mounted Police and the Reserve Force (the 'Pension Plans'). As of March 31 2020, PSP Investments had C$169.8B assets under management.

History and legal context of PSP Investments. PSP has a unique mandate and a governance structure tailored to that mandate. To understand and appreciate PSP's unique governance framework, it is important to consider the historical context that led to the creation of PSP in 1999. In the 1980s, the Auditor General of Canada released a series of reports on the finance and accounting practices associated with the various federal superannuation (pension) plans. Among the Auditor General's recommendations was a proposal to have the funds for federal employees gradually invested in marketable securities, in order to provide a sound financial basis for future benefits. In the mid-1990s, Canada undertook an important pension reform. The key driver for pension reform was concern surrounding the long-term financial sustainability of public pension plans in the face of the important expected pension payouts associated with an aging population and retiree longevity. These payouts were predicted to rise higher than could be financed on the basis of the 'Pay-As-You-Go' model. PSP was therefore created in 1999 by an Act of Parliament (the *Public Sector Pension Investment Board Act*) to invest the net contributions received from the Government from April 2000. Initially this reform covered the Canadian Forces, the Public Service, and the Royal Canadian Mounted Police DB pension plans; since March 1, 2007, it included the Reserve Force DB pension plan. PSP was given a clear statutory mandate and has operated at arms' length from the Government of Canada.

Mandate and nature of PSP Investments. PSP's mandate is to manage the pension funds transferred to it by the Government of Canada in the best interest of the contributors and beneficiaries, and to maximize investment returns without undue risk of loss, having regard to the funding, policies, and requirements of the Pension Plans. The Government of Canada manages and administers the Pension Plans, and PSP is the exclusive provider of investment management services to the Pension Plans. The rationale for creating the PSP was to help sustain the Pension

Plans by investing the amounts contributed in a professionally-managed diversified portfolio of capital market investments.

Review of the nature of the arm's length relationship. PSP's business and activities are managed and supervised by a board of Directors (the 'Board of Directors') appointed by the Government. In managing and supervising PSP, the Board of Directors does not receive directives, mandate letters, or follow other instructions from the Government. Indeed, the Board of Directors alone establishes the PSP's investment policies, standards, and procedures, although in doing so, the Board of Directors is required to have regard to the funding, policies, and requirements of the Pension Plans and their ability to meet their financial obligations. This is a factor differentiating PSP's governance, compared to certain peers whose Directors are not involved in the setting of investment policies nor do they have approval authority over investment decisions.

Investment approach. In keeping with PSP's legislative mandate, the Board of Directors annually approves the Policy Portfolio, which represents the long-term target asset allocation among broad asset classes. In addition to allocations to publicly traded equities and fixed income, PSP's Policy Portfolio includes an important allocation to private asset classes such as real estate, private equity, infrastructure, natural resources and credit investments. PSP is invested in both active and passive investment strategies managed in-house as well as by external managers and fund managers. PSP's portfolio diversified in terms of asset classes, and also in terms of geography, making PSP a true universal owner.

Responsible Investment at PSP Investments

<u>ESG Governance at PSP Investments.</u> In 2018, the sponsors of the Pension Plans adopted a Funding Policy stating an expectation that PSP would report in its Statement of Investment Policy Standards and Procedures, as well as other publicly available documents, how ESG factors are

incorporated into its investment practices (PSP 2020). It was the first time since PSP's inception that PSP was provided with an expectation on ESG matters from the Pension Plans sponsors. Nevertheless, PSP did not wait until 2018 to start its ESG journey. Rather, its first Social and Environmental Responsibility Policy—now known as the Responsible Investment Policy (PSP 2020)—was adopted in 2001, and it has been regularly reviewed since then to adapt to a changing world and reflect its current practices. The earliest version of the policy read:

> 'In carrying out this duty [to discharge PSP Investments' investment mandate], the board of directors recognizes that a broad range of factors may be relevant in assessing whether particular investments may properly be expected to contribute to or be detrimental to PSP Investments' ability to achieve its objects and perform its duties. Among other things, the environmental and social impact of the behaviour of corporations and entities in which PSP Investments may invest may be one of a number of relevant factors that our investment professionals would wish to take into account in making investment decisions for the [Pension] Plans.
>
> (…)
>
> To assist it in assessing the factors that guide and inform its investment decisions, PSP Investments encourages corporations and other entities in which it may invest to disclose regularly to their investors and potential investors the details of all policies, practices and matters that may be material to shareholder value. It is our view that reasonable and timely disclosure should be made by the corporations and entities in which we invest of their positions on all matters that may materially affect shareholder value. Where social and environmental issues are relevant and material, we would expect that they be included in that disclosure. All shareholders have a right to know about the activities of the corporations and entities whose securities they hold that are pertinent to the value of their investments.' (PSP 2001: 1)

The direction set by the Board of Directors in 2001 was anchored in the belief that environmental and social matters were relevant to investment decisions, especially when they could affect PSP's ability to provide for the financial benefit of the contributors to the Pension Plans and the Pension Plans' ability to honor the pension promises made to their contributors. This belief was not imposed by pension plan sponsors or by regulation. Instead, it was shaped through dialogue and several discussions between the board and senior management regarding the success factors for a long-term investor. This underscores how leadership and governance have been key facilitators of ESG integration at PSP. On this foundation, ESG developed from a risk management tool in 2001, to what is now an integrated investment decision factor.

<u>Other ESG enablers and inhibitors.</u> It is useful to note that the lack of ESG-related regulations in Canada either requiring the adoption of specific ESG practices or prohibiting ESG integration qualifies as an enabler of ESG policy. As opposed to a responsible investment approach being imposed by a regulator, it allowed for the development of an approach aligned with PSP's mandate, its investment strategy, and its total fund perspective. This enabler helped in building a strong level of conviction about ESG risks and opportunities within the organization.

Other key enablers of ESG implementation at PSP were related to the fund's long-term investment mandate and asset mix. For PSP moving into the ESG arena was seen as indispensable when investing in less liquid investments such as private assets. Accordingly, PSP adopted an ESG strategy early on which would ensure that ESG factors would be integrated in the investment process, from both a risk and an opportunity lens.

The COVID-19 pandemic has now amplified the importance of ESG issues for investors like PSP who seek greater transparency about how organizations are managing their ESG risks and integrating them into their business strategy. PSP is committed to bridging the gap between an ESG qualitative narrative and quantitative factor-driven analysis. Furthermore, PSP seeks to address this inhibitor by collaborating with peers, industry regulators, academia, and investee companies. This is one of the reasons why PSP joined its voice with other Canadian pension plan investment managers, calling on companies and investors to provide consistent and complete ESG information to strengthen investment decision-making and better manage ESG risk exposures (PSP 2020). It was the first time that the CEOs of Canada's eight leading pension plan investment managers issued a statement, but not the first time that these organizations collaborated to more effectively deploy resources and encourage ESG best practices.

<u>PSP Investments' ESG strategy.</u> To take into account the world of tomorrow, PSP factors ESG risks and opportunities into its investment processes—with a view to enhancing performance, steering capital towards more attractive areas, and mitigating potential issues. As part of its investment analysis and decision-making processes, PSP identifies material ESG risks and opportunities that could impact its investments long-term financial performance. PSP also leverages its ownership positions to promote good governance practices, by exercising its proxy voting rights and actively engaging with boards and management of investee companies on material ESG risks and opportunities. When PSP allocates a portion of its capital to externally-managed mandates and fund investments in public and private market portfolios, it engages regularly with its external partners on ESG topics throughout the investment lifecycle. To ensure that the ESG integration approach for each externally-managed mandate and fund investment is consistent with its Responsible Investment Policy and expectations, PSP has developed an in-house proprietary assessment framework that evaluates and ranks by quartile the overall external managers' and general partners' ESG practices. The quartile ranking helps the board by

prioritizing engagement, sharing of best practices, and measuring progress of ESG integration in investment decision-making and asset management over time.

Responsible investment at PSP is an active process that addresses ESG factors across all asset classes. PSP's investment teams evaluate ESG risks and opportunities in order to make more informed investment decisions, by the dedicated Responsible Investment group housed in their Chief Investment Officer group. This group works to oversee and implement responsible investment activities across the total fund, provide guidance on ESG themes and trends, build internal capacity through ESG knowledge sharing, and collaborate with industry peers to drive systemic change on key ESG issues.

Conclusion

This paper has discussed the origins of ESG in pensions by reviewing the characteristics of pension funds how they can integrate these ESG factors into investment decisions. Drawing on existing literature, a range of interviews, and an in-depth study of PSP Investments, we showed how different institutional, organizational and investment factors play a role. We identified three levels for whether and how pension funds can integrate ESG: *the institutional level,* which sets the historical and regulatory context of the interpretation of fiduciary duty; *the organizational level,* which decides how investment mandates are translated into policies, governance structures, and collaborations; and *the portfolio level,* which implements investment strategies through asset allocation, the mandates to asset managers, and stewardship activities.

When reviewing these characteristics, we note that pension funds are not a homogenous community. They have different mandates, legal environments, and governance structures to work with. Despite this diversity, pension funds share a common objective, which is to identify the best investments or investment strategies to generate investment returns to be able to pay pensions to their beneficiaries for generations to come. In so doing, the inherent long-term investment time horizon and the diversified portfolio structures are often seen as the two of the principal ESG enablers in pension funds, where the growing evidence about ESG materiality requires pension funds to integrate them as risk factors in investment decision-making. How these factors will ultimately be taken into consideration must depend on discretion of the pension fund, governance structures, leadership, and the plan's investment policy suitability for the fund's asset mix. The freedom of pension boards and leaders to do this, however, can be restricted through lack of clear guidance on ESG expectations from plan sponsors or regulators. Additionally, regulators can inhibit the integration of ESG by placing large reporting burdens on pension funds, therefore making ESG an expensive use of resources.

Finally, pension funds have grown to be powerful forces in the investment market, and they have an opportunity to further catalyze the market-wide integration of ESG factors. To do so, they should focus not on what differentiates them, but rather what they have in common. All pension funds have limited resources, yet collaboration and coordination can be key enablers for them to speak with one voice, and to make that voice heard more loudly and persuasively. Possible targets of such coordination, like disclosure standards and standard mandates for external managers, can help facilitate a deeper integration of ESG in the entire investment chain.

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Endnote

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

[2] The markets included in this study are Australia, Brazil, Canada, Chile, China, Finland, France, Germany, Hong Kong, India, Ireland, Italy, Japan, Malaysia, Mexico, Netherlands, South Africa, South Korea, Spain, Switzerland, the UK, and the US.

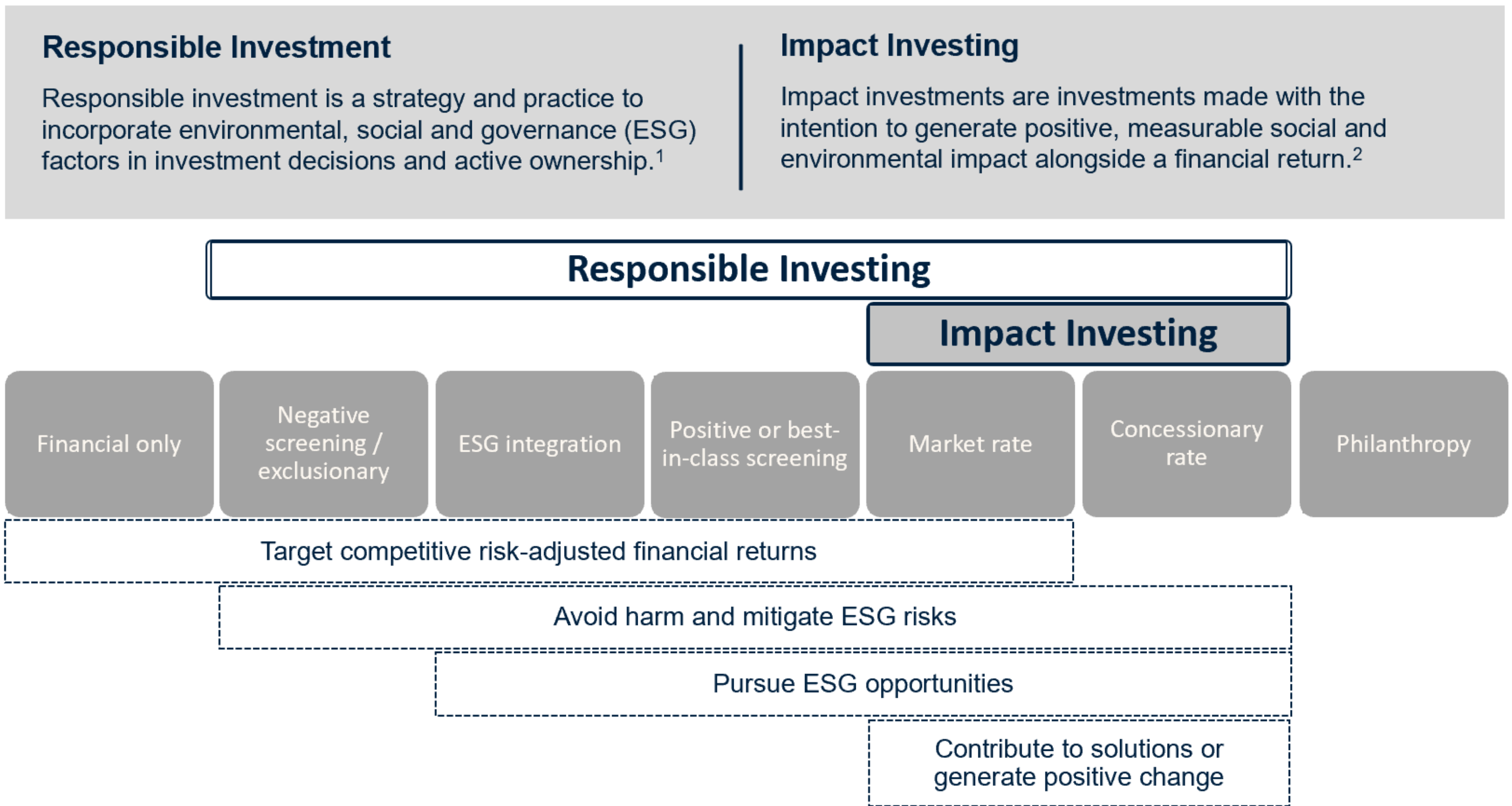
[3] OECD Global Pensions Database, https://stats.oecd.org/Index.aspx?DatasetCode=PNNI_NEW

[4] This is calculated from the value of the US equity market (12/2020: $50.6 trillion USD), the global equity market (12/2020: $95 trillion), and the equity-held percentage of pensions in the US (32.7 percent of $32.2 trillion in 2019). In the UK, the sum is based on 11% of $3.6 trillion USD EUM relative to $5 trillion USD, and in Canada on 21.8% of $2.8 trillion USD EUM relative to $3.2 trillion USD. Data from Toronto Stock Exchange, OECD Pension Stats and Bloomberg Finance.

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

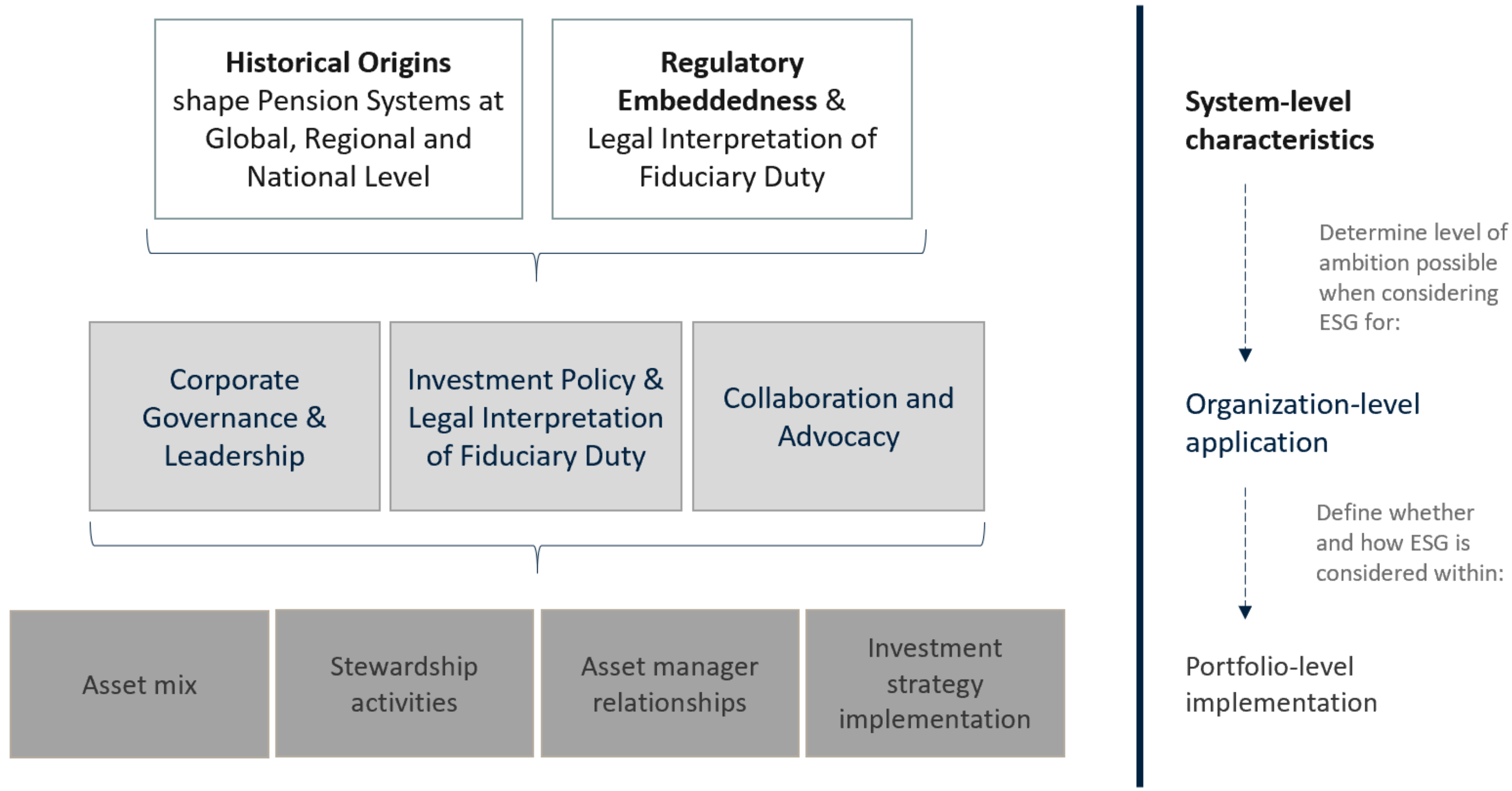
[6] Representing the interests of institutional investors, the Canadian Coalition for Good Governance promotes good governance practices in Canadian public companies and the improvement of the regulatory environment, to best align the interests of boards and management with those of their shareholders,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

Figure 1. The spectrum of choices for investors.



Source: Authors' elaboration of Information and classification based on 1) UN PRI (2021a), and 2) GIIN (2021).

Figure 2. Characteristics of pensions relevant for ESG



Source: Authors' elaboration.

Note: This framework illustrates aspects of the institutional, organizational, and portfolio level, without a comprehensive representation of activities at each level.

Appendix

Interviews conducted for this paper:

- PSP, Canada; January 2021
- CalSTRS, United States; January 2021
- University Superannuation Scheme USS, United Kingdom; January 2021

Other Interviews also drawn on:

- NYCC, United States; December 2020
- OTTP, Canada; December 2020
- PGGM, Netherlands; December 2020
- AP2, Sweden; December 2020
- AP3, Sweden; December 2020
- AP7, Sweden; December 2020
- AWARE, Australia; December 2020