Protecting Pensions:

Pension plans across Canada have been increasing their focus on socially responsible investing away from systemic risks. The author presents the potential financial advantages and challenges pension fund fiduciaries face when managing plan assets and influencing positive change in the uncertain future.

Effective Governance of Climate and ESG Risks

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Climate impacts are growing globally. In 2021 alone, Canada had 1,600 wildfires. The U.S. National Interagency Fire Center reports a total of 58,733 wildfires that have burned 7.13 million acres in the U.S. as of 2021.[1] Flooding has caused serious damage in both countries, amounting to billions of dollars in losses. The impacts of climate change are poignantly real. Environmental, social and governance (ESG) issues and concerns can no longer be relegated to debates among pension fiduciaries about values investing or investment value (returns) but, rather, need to be addressed holistically.

There are 6.5 million Canadians covered by more than 16,000 registered pension plans with $2.18 trillion assets.[2] Only 32 of those plans account for 50% of all plan membership. The vast majority of Canadian pension fiduciaries rely on a variety of service providers (such as investment managers, mutual fund and trust companies, and life insurance companies) to establish and implement investment policies, which becomes important in thinking about how we approach ESG.

Environment includes how pension funds and their investments impact and are impacted by climate change and broader environmental issues such as protection of biodiversity. *Social* includes factors ranging from modern slavery to equity, diversity and inclusion. *Governance* is the effectiveness of risk management, strategic planning and investment processes for long-term delivery of the pension promise, as well as the accountability structures in place for pension trustees, administrators and service providers.

Pension Fiduciary Duties

Pension plan fiduciaries have a duty to acquire an understanding of, and then balance their decisions in respect of, current and future intergenerational risk and return over periods that potentially exceed human lifetimes. Pension funds are large, diversified institutional investors with long-term investment horizons, so they cannot diversify away from systemic risk such as climate change and income inequality, and that system-level investment lens needs to be keenly attuned to intergenerational responsibilities as part of their fiduciary duties. The prudential obligation requires fiduciaries to act with the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person. The duty of loyalty requires pension fiduciaries to act in the best interests of plan members and to avoid conflicts of interest. They also have a duty of evenhandedness as between different classes of beneficiaries.

Evaluating ESG-related risks and opportunities goes beyond passive receipt of information, and instead means establishing a robust process to oversee and verify the funds' progress in relation to these risks and opportunities. The United Nations Environment Programme Finance Initiative and Principles for Responsible Investing report that pension fiduciary duties require pension trustees and other fiduciaries to incorporate ESG issues into investment analysis and decision-making processes, consistent with their investment time horizons; encourage high standards of ESG performance in their portfolio companies; understand and incorporate beneficiaries' sustainability-related preferences; and report on how they have implemented these commitments.[3]

From Voluntary to Mandatory

The most notable trend in the past year is the shift from voluntary to mandatory standards. In 2021, the United Kingdom (U.K.) government introduced new legal duties for the U.K.'s £2 trillion investments pension funds, requiring pension trustees to assess and publish the financial risks of climate change within their portfolios. Effective October 2022, trustees will have to disclose how their investments align with COP26 goals of transition to net-zero emissions.

Accounting standards are also converging. The new International Sustainability Standards Board (ISSB) has two exposure drafts—International Financial Reporting Standards (IFRS), S2 *Climate-related Disclosures* and IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information*—which will create accounting standards on disclosing information about significant climate- and sustainability-related risks and opportunities that are useful to the primary users of general purpose financial reporting, including governance processes, controls and procedures used to monitor and manage risks.[4]

The Canadian Association of Pension Supervisory Authorities (CAPSA) is developing a principles-based guideline on the integration of ESG factors in pension fund investment and risk management.[5] The Office of the Superintendent of Financial Institutions (OSFI), which supervises federally regulated pension plans for financial soundness, in March 2022 released a consultation paper on pension investment risk management, observing that "good pension plan governance includes elements such as robust processes to identify and manage more complex investment risks, independent oversight of risk-taking activities and appropriate risk controls."[6] OSFI is collaborating with CAPSA in developing guidance on integrating ESG factors in pension fund investment and risk management.[7]

In the U.S., pension funds have been hit with revolving door policies of the Department of Labor (DOL), which under the Trump administration held retirement plan fiduciaries to a "pecuniary" standard when selecting investment options, questioning the appropriateness of social investing in defined benefit plans covered by the Employee Retirement Income Security Act of 1974 (ERISA). The Biden administration has suspended enforcement of that rule,[8] and the DOL's proposed new rule "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" states that when considering projected returns, a fiduciary's duty of prudence may often require an evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action.[9] As of May 2022, the DOL is moving to next steps toward implementation. In the interim, it issued a request for information in which the Employee Benefits Security Administration is asking for public input on its future work relating to retirement savings and climate-related financial risk and actions that can be taken under ERISA and the Federal Employees' Retirement System Act of 1986 (FERSA) to protect pensions from climate-related financial risks.[10]

Climate Risk Is Particularly Urgent

Focusing on climate risk is a particularly urgent issue; there is now broad-based acknowledgement that climate change is an existential threat. The Intergovernmental Panel on Climate Change, which represents a broad consensus of 800 scientists representing 140 countries, calls for immediate, rapid and large-scale reductions in greenhouse gas (GHG) emissions, which requires a significant shift of investment into sustainable projects and green technology. It reports that the burning of fossil fuels is the main source of GHG emissions that have led to the current climate crisis and cautions that the emissions from existing and planned fossil fuel infrastructure alone are higher than in scenarios consistent with limiting warming to 1.5°C.[11] The convergence of scientific evidence and government policy means that pension fund trustees, in fulfilling their duties to beneficiaries, have an obligation to identify and address climate-related financial risks. Trustees can take climate change into account as a legitimate investment issue over the short, medium and long term. If trustees fail to act to address material climate-related matters, they may be held personally liable for breach of their fiduciary obligations. Pension funds will potentially lose significant value of their investments if they do not act as prudent investors by recognizing and managing climate-related risks and opportunities. Trustees, administrators and their service providers can also take climate change into account because they have duties as public fiduciaries additional to their financial duty to beneficiaries. Fiduciary obligation also requires considering the benefits of investment in green adaption and mitigation technologies and other products and services that are likely to have upside financial potential for return on investment.

A legal opinion released by Randy Bauslaugh of McCarthy Tétrault in 2021 opines that pension fund fiduciaries have a duty to take into account financial risks and opportunities when managing plan assets.[12] Duties include adequately as-

Takeaways

- The vast majority of Canadian pension fiduciaries rely on a variety of service providers—such as investment managers, mutual fund and trust companies, and life insurance companies—to establish and implement investment policies. Fiduciaries have a duty to acquire an understanding of, and then balance their decisions in respect of, current and future intergenerational risk and return over periods that potentially exceed human lifetimes.
- Accounting standards are being merged in an effort to disclose information about significant climate- and sustainability-related risks and opportunities that are useful to the primary users of general purpose financial reporting, including governance processes, controls and procedures used to monitor and manage risks.
- In 2020, three of the largest pension funds globally—California State Teachers' Retirement System (CalSTRS), the Japanese Government Pension Investment Fund (GPIF) and the U.K. Universities Superannuation Scheme (USS)—joined in a public statement aligning their commitment to work with asset managers that integrate ESG factors throughout their entire investment and corporate engagement processes.
- Fiduciary obligation also requires considering the benefits of investment in green adaption and mitigation technologies and other products and services that are likely to have upside financial potential for return on investment.

sessing and managing climate-related financial risk, reporting to beneficiaries and other stakeholders on how these risks are being managed, and taking decisive action to mitigate these risks. Bauslaugh reports that administrators and trustees responsible for investment of pension funds are fiduciaries under the common-law and civil law in Canada, and the Supreme Court of Canada has expressly held that there are circumstances in which a pension plan administrator has fiduciary obligations to plan members both at common law and under statute. He observes that in defined benefit plans, positive financial performance results in greater financial security for plan participants and lower cost for employers, as they are directly responsible for funding shortfalls; and in defined contribution plans, successful investment performance means greater retirement income for plan participants and less pressure on employers to improve contribution rates or top-up pension accumulations to encourage a transition to retirement.

While there are not currently pending cases against Canadian pension funds, litigation risk is growing. For example, a member of an Australian pension plan brought a lawsuit against pension trustees for failure to identify, manage and disclose climate risks. The lawsuit settled on the eve of the hearing, with the trustees acknowledging that climate change is a material financial risk to the fund. The trustees also committed to actively identify and manage climate risks throughout the fund's portfolio and to take steps to ensure that investment managers actively consider, measure and manage financial risks posed by climate change and other relevant ESG risks.[13]

Direction of Travel for Pension Funds as Investment Fiduciaries

Total assets incorporating ESG principles managed by U.S. institutional investors have grown appreciably to US$6.2 trillion as of 2020, with public pension funds accounting for 54% of those assets.[14] Over US$40 trillion in global assets under management apply at least a partial restriction on oil and gas,[15] and 180 pension funds have divested these investments.[16] For example, in 2021, the New York City Employees' Retirement System (NYCERS) and the New York City Board of Education Retirement System (BERS) announced the successful divestment of securities related to fossil fuel companies, bringing the total divestment across all funds to US$3 billion.[17]

We increasingly see alliances of pension funds in their commitments to ESG. In 2020, three of the largest pension funds globally—California State Teachers' Retirement System (CalSTRS), the Japanese Government Pension Investment Fund (GPIF) and the U.K. Universities Superannuation Scheme (USS)—joined in a public statement that said, "If we were to focus purely on the short-term returns, we would be ignoring potentially catastrophic systemic risks to our portfolio," and they committed to working with asset managers that integrate ESG factors throughout their entire investment and corporate engagement processes.[18] The CEO of the eight largest Canadian pension funds, "the Maple 8," made a pledge to create sustainable and inclusive growth by integrating ESG factors into their strategies and investment decisions as a fundamental part of their duty to beneficiaries.

Ontario Teachers Pension Plan, managing $241.6 billion, has committed to achieving net-zero portfolio emissions by 2050 and reducing portfolio emissions intensity by two-thirds below a 2019 baseline by 2030.[19] It states that "for the avoidance of doubt, any investment that increases the use of fossil fuels would not support a transition to a low carbon economy and would not be a green investment under our principles."

In 2021, Caisse de dépôt et placement du Québec (CDPQ), with $420 billion in net assets invested, announced that it is divesting all of its oil production investments by end of 2022, aiming to achieve a 60% reduction in the carbon intensity

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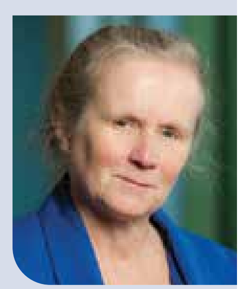

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of its total portfolio by 2030 compared to 2017 and creating a $10-billion transition envelope to decarbonize the heaviest emitting sectors. It has grown its low-carbon investments to $39 billion in 2021.[20] It has made equity, diversity and inclusion policy implementation a priority.

Action Items

The direction of travel is clear—ESG is now a core consideration, and pension fiduciaries are well-advised to do the following.

- Oversee the responsible investing program and approve ESG-related investment policies (e.g., SIPP), drilling down to the most urgent ESG concerns.
- Integrate ESG factors at all stages of the investment process, including a due diligence process for new investments and active engagement with portfolio companies on ESG matters, including meetings, use of proxy voting and election of directors.
- Develop a policy to transition portfolio investments and in-house pension plan operations to net-zero carbon emissions with interim and longer term targets, with processes to measure annual achievement of goals.
- Provide guidance regarding ESG expectations for staff appointed to sit on boards of portfolio companies, including a robust, timebound, escalatory policy that sets expectations on ESG priorities.
- Ensure processes are in place for executives to manage material ESG risks across investment portfolios, with clear accountability and regular reporting to the board.
- Review and approve annual ESG-related objectives and milestones reached, including how they are used to assess performance and determine annual compensation.
- Set milestones for enhancing diversity, equity and inclusion within the pension fund workforce, and create similar expectations for service providers and portfolio companies.
- Carefully examine recommendations of the Truth and Reconciliation Commission and recent federal and BC legislation incorporating commitments under the UN Declaration on the Rights of Indigenous Peoples to develop strategies for partnerships with Indigenous Peoples.
- Disclose to beneficiaries exactly how the financial success of ESG investment strategies aligns with the long-term interests of beneficiaries.
- Ensure that all actuaries, consultants and accountants hired to provide independent reviews of financial risks have adequate climate expertise.

Endnotes

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