

# OECD ANALYTICAL REPORT ON INVESTMENT GOVERNANCE AND THE INTEGRATION OF ESG FACTORS

June 2016

This document provides a progress report on the OECD project on “Investment Governance and the Integration of ESG factors”. The findings herein are preliminary and subject to change. A draft final report will be prepared for submission to the relevant OECD committees in December 2016.

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# OECD Analytical report on investment governance and the integration of ESG factors

## *Summary of findings to date*

*June 2016*

### **Background**

1. The OECD was asked by the French Presidency of the COP21 to launch work on the governance of investments by institutional investors in relation to ESG factors and risks, in particular those associated with climate change. The principle of developing such work was already agreed by the OECD Working Party on Private Pensions in December 2015.

2. The objective of this project is to conduct an international stock-taking of the regulatory frameworks that apply to institutional investment in various jurisdictions and how these frameworks are interpreted by institutional investors in terms of their ability or responsibility to integrate ESG factors in their governance processes. This will result in a report which may lead to further analysis to identify current good practices within the policymaking and business communities related to ESG investment risks and opportunities and how these practices are evolving.

3. This stock-taking initiative aims to improve our understanding of the extent to which policy and business frameworks support the systematic inclusion of ESG factors in the governance of institutional investments; how institutional investors interpret their obligation towards beneficiaries in terms of ESG analysis; how ESG analysis is implemented in practical terms in their investment decisions; and whether institutional investors have access to the necessary analytical tools. It will also address the issue of disclosure by institutional investors of their investment decision process and the relevant criteria for such disclosure towards different audiences.

4. Additionally, it should provide guidance on what actions might be required from the institutions in which institutional investors invest, for example in terms of ESG corporate disclosure; whether or not there is a need to streamline and co-ordinate national efforts; and how ongoing work on benchmarking and disclosure approaches related to carbon risk can complement efforts to reinforce governance approaches.

### **Work undertaken to date**

5. Work undertaken to date consists of the following:

- Face-to-face interviews have been held with a number of large institutional investors to collect information on their approach to ESG investing.
- Following these interviews, surveys have been sent to pension funds, insurance companies and asset managers to follow up on areas of particular interest highlighted by the interviews and to complete our picture of how institutional investors integrate ESG factors.
- Surveys have also been prepared and sent to regulators in OECD and non-OECD jurisdictions to gather information and views from regulators and policymakers on the policy drivers shaping institutional investment governance.
- A review of the academic literature on the fiduciary duties of institutional investors and a review of evidence of the financial impact of ESG factors on portfolio investments.

6. The OECD Secretariat has prepared preliminary findings on the fiduciary responsibilities of institutional investors towards their beneficiaries and what this means for the integration of ESG factors in investment decisions; the impact of ESG factors on expected performance; how institutional investors integrate ESG factors and potential obstacles to ESG investing; and where there may be a role for regulators to intervene to support efforts to understand and manage ESG risks. It presented these findings to the relevant committees (principally the Working Party on Private Pensions and the Insurance and Private Pensions Committee) in early June for comment and feedback. The selected discussion points below are taken from this larger document.

7. These findings will be supplemented by information from surveys that have been circulated to regulators and institutional investors as well as by further desk research in order to prepare a draft final report for submission to the relevant committees in December 2016.

## **Selected discussion points**

### ***Fiduciary responsibilities and the integration of ESG factors***

8. Many institutional investors are not bound by the legal concept of fiduciary duty, in common law as well as civil law jurisdictions<sup>1</sup>. Nonetheless, the debate over the interpretation of fiduciary duty is relevant to the majority of institutional investors, as it addresses the core issue of how institutional investors understand their responsibilities to beneficiaries and what this means for the integration of ESG factors in investment governance. Related considerations include: evolving views of what constitutes prudent investment, how the portfolio risk of climate change is assessed, regulatory developments around responsible investing, technical capabilities and competing priorities.<sup>2</sup>

9. For institutional investors who are subject to fiduciary duty, there appears to be no legal conflict between this status and integrating ESG factors in investment governance. To the extent that ESG factors are expected to have a material financial impact on portfolio performance, legal and regulatory frameworks provide ample scope to incorporate ESG factors in investment policies following developments such as the recent ERISA amendment in the US<sup>3</sup> and the report of the UK's Law Commission.<sup>4</sup> Institutional investors who have a purely contractual relationship with their beneficiaries can also integrate ESG factors into their investment processes as a means of enhancing their analytical capabilities.

10. Nonetheless, some difficulties remain for investors in reconciling their obligations towards their beneficiaries and integrating ESG factors in their investment governance. These difficulties are largely practical, although several institutional investors reported that there was a behavioural element as well, in that integrating ESG analysis involves asking different kinds of questions from traditional financial analysis.

### ***Distinguishing between ESG integration and “ethical” or “impact” investing***

11. There is some confusion between ESG investing (considering ESG factors to help to determine the value of a security) and types of ethically motivated investing (considering ESG factors to see if a

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1. For example, the governance of contract-based pension schemes managed by insurance companies in the UK does not assume a fiduciary relationship between the insurer and the member.

2. This list may change as further information is collected from regulators and investors.

3. ERISA Interpretive Bulletin 2015-01, effective 26 October 2015

4. “Is it Always About the Money? Pension Trustees’ duties when setting an investment strategy: Guidance from the Law Commission”, July 2014.

security is consistent with a set of values) such as “socially responsible investing” or “impact investing”. This lack of clarity, and in particular any lingering suspicion that ESG integration is motivated by ethical or moral concerns rather than by financial concerns, has probably delayed the integration of ESG factors in investment governance. This difficulty is compounded by the speed at which new ESG investment strategies and practical tools to implement them are developing, making it harder for institutional investors to select the “right” strategy.

12. Institutional investors focus on financial returns. A large UK DB scheme, which has an explicit social mission and a stated investment view that “good ESG is good business”, nevertheless felt that it could not sacrifice financial returns in order to invest in a company that performed particularly well on social criteria. Another, similar scheme which has a “responsible investment” policy was also clear that a good ESG score would not outweigh a poor financial score when making investment decisions, as their fiduciary duty was “to pay pensions”.

### ***Understanding the potential financial impact of ESG factors***

13. There is growing consensus that ESG factors have a material impact on corporate financial performance. Financial markets reward good ESG performance by corporates, while poor ESG scores are an indicator of increased idiosyncratic risk, because they imply that the company is less efficiently managed than its peers. However there is less conclusive evidence about how this is translated into stock market performance. A USD 60 billion asset manager with a largely quantitative investment process reported that while companies that scored well on ESG criteria tended to be more profitable and grow faster than their peers and that this was quickly rewarded by the market, there was not yet a reliable quantitative signal that the market punished weak ESG performers.

14. Institutional investors are familiar with the idea that ESG factors can affect the valuation of individual securities; general ESG integration is increasingly common but by no means universally applied. Institutional investors cited a number of difficulties related to identifying and valuing ESG risks and opportunities that have slowed down the adoption of ESG integration; in particular data availability, valuation techniques and modelling constraints.

15. They are less focused on the top-down risks of ESG factors to the portfolio as a whole, in part because they are less equipped to model the discontinuous and extreme risks associated with climate change in particular.

### ***Implementing an ESG investment strategy***

16. It is not always straightforward to understand the effects of ESG risks and opportunities at the company level in such a way that these can be incorporated into typical financial models:

- Data availability: investment analysis is limited by corporate disclosure, which is variable in quality and scope. It is also limited by investors’ understanding of that data and which metrics are relevant to a particular investment case.
- Modelling: ESG factors cannot necessarily be integrated into financial models, as they do not always have a short-term financial impact. Furthermore, most financial models are built on historical data, which may be less relevant for forecasting future ESG-related outcomes. Notably, a lot of ESG models focus on risks, there are fewer tools for assessing positive ESG performance.

- Valuation techniques: equity investors can adjust corporate valuations for ESG factors in a number of ways. Investors tended to vary the discount rate applied to future corporate cash flows – which raises the question of how steep a discount should be applied to various kinds of ESG risk.

17. As a result of these difficulties, ESG analysis usually takes the form of a qualitative input that is used alongside traditional quantitative models.<sup>5</sup> An example of the way ESG analysis is integrated into portfolio decisions is in the form of a “quality/ESG score” which is used alongside a “value/financial score” generated by financial models. The portfolio manager might use the quality score just for information, or might set a hurdle such as a minimum 75% quality score for a stock to be included in the portfolio.

18. A number of the institutional investors interviewed cautioned that ESG analysis could be less well respected by portfolio managers than financial analysis because it was not quantitative and that it was therefore harder to convince them to take it into account. This was true even when ESG analysts were part of the generalist portfolio management team.

19. Many institutional investors use a variant of “exclusion” or “best in class” strategies – such strategies may reduce certain types of ESG exposure but they do not necessarily contribute to climate goals.

### ***Balancing the impact of ESG factors over different time horizons***

20. Despite the long-term nature of their liabilities, institutional investors may take a short-term view of their investment performance, because of the prevalence of quarterly reporting cycles for both investors and the companies in which they invest, as well as mark-to-market evaluations. In addition, fiduciaries may fear that there is a trade-off between the interests of today’s and tomorrow’s beneficiaries; for example, a pension fund trustee might believe that a company that is seeking new funding will create severe environmental damage in the long run, but that its shares will do very well in the short term. Should the investor buy the stock today in order to reap the benefits for current retirees, or decide not to help finance the company because of the threat to future retirees? One pension fund argued that institutional investors were unlikely to be able to beat hedge funds and other specialists at market timing and short-term stock-picking, so it is better for all beneficiaries if they focus instead on longer-term, fundamental drivers of return.

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5. It should be remembered that even quantitative financial models such as DCF forecasts may rely on qualitative elements such as analysts’ forecasts of future demand.