# CAPSA Guideline

# Environmental, Social and Governance Considerations in Pension Plan Management

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# 1. INTRODUCTION

The Canadian Association of Pension Supervisory Authorities (CAPSA) developed this Guideline to provide guidance for the consideration of environmental, social and governance (ESG) issues in pension plan management.

This Guideline aims to support plan administrators in fulfilling their fiduciary obligations and giving appropriate consideration to ESG factors that may have financial relevance to their plan's investments and risk management frameworks.

This Guideline should be read in conjunction with the following CAPSA Guidelines:

- No. 4: Pension Plan Governance Guideline; and
- No. 6: Pension Plan Prudent Investment Practices

These Guidelines provide foundational guidance in their core areas of pension plan management. In this Guideline, CAPSA has avoided replicating concepts already covered by the other Guidelines. This Guideline complements and expands on these concepts to specifically address ESG factors.

## 1.1. ESG, Climate Change, and the Role of this Guideline

For the purpose of this Guideline, ESG factors can be understood as qualitative or quantitative ESG information that may positively or negatively affect assessments of the financial performance of individual companies, industries or markets generally.

Among ESG issues that may have the potential to affect risk and return (e.g., labour standards, diversity, specific governance practices), climate change is now accepted as posing material and urgent financial risks and opportunities. Climate change affects the financial system as a whole (i.e., it is systemic) as well as individual companies and industries. The effects of climate change include both physical risks and transition risks.[1] Climate change is therefore an important ESG factor for consideration by pension plans.

CAPSA recognizes that pension plans come in a variety of forms and sizes and can have different investment beliefs and strategies. Plans will differ in the ways they approach ESG issues. The principles identified in this Guideline apply to all types of defined contribution (DC), defined benefit (DB) and target benefit pension plans,[2] including single employer, jointly sponsored and multi-employer pension plans, and are intended to be applied by plans proportionately relative to their circumstances.

[1] Physical risks include rising sea levels, increased flooding, extreme heat events and wildfires. Transition risks are those risks associated with transitioning to a more sustainable economy and include inadequate disclosure practices, shifting asset values, changes in consumer preferences and changes in regulations, technology and business practices.

[2] In the interest of brevity, in this Guideline the term DB is intended to refer to both DB and target benefit pension plans.

# 2. ESG AND THE FIDUCIARY DUTY OF PLAN ADMINISTRATORS

The primary purpose of a pension plan is to provide lifetime retirement income.[3] When administering and investing pension plan assets, plan administrators must act in accordance with their fiduciary duty in fulfilling this purpose.[4]

## 2.1. What does this fiduciary duty mean in the context of ESG?

Principle 1: Pension plan administrators (either directly or through their delegates) should consider ESG characteristics that may have material relevance to the financial risk-return profile of the pension fund's investments.

There is potential for ESG factors to provide valuable insight on investment risks and opportunities, and to have a material effect on investment returns over varying time horizons. It is the administrator's responsibility as a fiduciary to act prudently to identify risks and opportunities that may impact the plan.

Administrators should therefore consider whether any particular ESG factors are relevant to investment performance and take appropriate action based on that determination. Using ESG factors to provide financial insight is consistent with an administrator's fiduciary duty. Conversely, ignoring or failing to consider ESG factors that may be potentially material to the fund's financial performance could be a breach of fiduciary duty.

Plan administrators may determine it is consistent with their fiduciary duty to use ESG information, including ethical or impact investing considerations, as a deciding factor between otherwise equivalent investment options (that is, options that provide equivalent expected risk-return results). This may arise in the context of investment selection or divestment but also stewardship activities such as engagement and proxy voting. Plan administrators should ensure that any such practices remain consistent with their fiduciary obligation – which is to fulfill the primary purpose of the plan in providing retirement income.

Similarly, in the context of a DC plan that provides members with choice in selecting investments, plan administrators may determine it is consistent with their fiduciary duty to include in the plan's investment line-up an "ESG fund" – in other words, a fund that places additional emphasis on ESG factors in its mandate or strategy. Plan administrators should



[3] In Canada, Income Tax Regulations, subsection 8502(a) states that "the primary purpose of the plan is to provide periodic payments to individuals after retirement and until death in respect of their service as employees."

[4] For more information on fiduciary duty, please refer to [CAPSA Guideline No. 4 – Pension Plan Governance Guideline](CAPSA Guideline No. 4 – Pension Plan Governance Guideline).

similarly ensure that the inclusion of such a fund remains consistent with their fiduciary duty and the primary purpose of providing retirement income.[5]

# 3. IMPLEMENTING ESG CONSIDERATIONS IN PLAN ACTIVITIES

Governance, risk management and investment decision-making are key plan activities in which ESG factors may be integrated. Given that pension plans come in a variety of forms and sizes, the application of the following principles relating to these areas needs to be appropriate for the context of individual plan circumstances.

The range of issues brought to light by ESG factors are constantly evolving as are the methods and procedures for incorporating ESG factors into governance, risk management and investment decision-making. Accordingly, practices should be adaptive, responsive and regularly reviewed to assess emerging gaps, risks and opportunities.

Principle 2: Plan administrators, as part of their standard of care, need to assess whether their plan governance, risk management and investment decision-making practices are sufficient to identify and respond to material ESG information in a manner proportionate to their plans and appropriate for their investment beliefs.

## 3.1. Governance

CAPSA Guideline No. 4: Governance sets out the general expectations of CAPSA with respect to plan governance. With respect to ESG specifically, plan administrators should ensure that proper structures and processes are in place to facilitate the oversight of any risks and opportunities associated with ESG factors that may have a material impact on the plan.

Given the evolving nature of ESG considerations, ensuring prudent governance practices in relation to ESG creates a need for plan administrators to address whether they have the relevant skills, resources and experience, and / or obtain third-party expertise as needed to ensure they are meeting their standard of care. Third-party expertise can include:



[5] An example of such an “ESG fund” might be a fund that pursues certain ESG goals or impacts (e.g., exclusion of fossil fuels or targeted investment in green technology) of interest to the plan membership. Legal and investment advice can assist plan administrators in understanding any potential risks associated with including such a fund or funds in the investment line-up. Risks could include the effect of (a) the fund’s mandate on risk-adjusted return relative to other investment options of the same asset class, and (b) providing too much investment choice to plan members (i.e., complicating the decision architecture for plan members and increasing their information needs for investing in such a fund).

- Obtaining legal advice regarding fiduciary duty, the appropriate use of ESG information and the plan's disclosure to stakeholders about its approach to ESG considerations; and
- Seeking advice from third-party risk management and investment advisors with expertise in ESG matters to ensure processes are in place to help identify and respond to vulnerabilities and opportunities posed by ESG considerations.

As plan governance oversees all plan activities, plan administrators may find it useful to develop, and record in written policies, a set of investment beliefs or principles about ESG factors and their application to investment performance. Such an exercise can facilitate a deeper and more coherent understanding within the administrator. Once developed, these beliefs or principles can be helpful in guiding investment decision-making and influencing risk management processes. They can be embedded in investment and risk management activities of the plan through the statement of investment policies and procedures (SIPP), risk management framework and other relevant policies (e.g., external manager selection and due diligence frameworks, and stewardship).

## 3.2. Risk Management – Framework

Principle 7 of the CAPSA Guideline No. 4: Pension Plan Governance states that "The plan administrator should establish and document a framework and ongoing processes, appropriate to the pension plan, to identify and manage the plan's risks."

ESG factors that have the potential to materially affect the plan should not be considered differently than any other types of risk. However, ESG risks may have important characteristics relevant to risk identification, evaluation, prioritization and management that should be considered such as:

- Complexity.
- Longer time horizons.
- Interrelatedness / correlation with other risks.
- Limited or incomplete information or disclosure.
- An evolving understanding of their impact and effective management strategies.

Ensuring proper consideration of potentially relevant ESG considerations in a risk management framework may therefore involve controls in the form of ongoing analysis, education and training around relevant ESG factors – in addition to specific controls such as to limit exposure to a particular ESG risk.

Ultimately, understanding risks associated with ESG can help to inform the administrator's understanding of the pension fund's overall investment risk profile. This, in turn, can inform an understanding of the potential for variations in the plan's funded status and, depending on the terms of the plan, the necessity for additional contributions and benefit adjustments.

These are both important considerations relevant to the plan administrator's standard of care.

#### 3.2.1. Risk Management – Plan Sponsor

Where ESG considerations present material risks to the plan, they may also be relevant to the risk management activities of plan sponsors and vice-versa. Both the plan administrator and sponsor may therefore benefit from better understanding the risks impacting each other.

For example, where the sponsor is responsible for any funding deficiency in the plan, a better understanding of ESG related risks that are relevant to the plan means a plan sponsor can be more informed about its future funding obligations, potential variability in these obligations, and how these risks might affect the plan's funded status now and in the future. These considerations may inform the plan sponsor's own risk assessment in terms of its tolerance for managing fluctuations in its contribution requirements.

Conversely, plan administrators may also need to consider ESG considerations that may highlight risks to the ability of the sponsor to continue to fund the plan.

### 3.3. Investment Decision-Making

#### 3.3.1. Investment Strategy

CAPSA Guideline No. 6 (Prudent Investment Practices) identifies several principles for prudent investment, including principles regarding investment objectives, risk tolerance, prudent delegation and monitoring. ESG considerations are potentially relevant to the application of all of these principles.

In keeping with their ESG investment beliefs, plan administrators should therefore consider their processes for identifying and taking into account material ESG considerations in adopting investment strategies, such as with respect to asset allocation decisions, benchmark selection and use of external investment managers. Establishing limits, targets or standards may be helpful methods for plan administrators to operationalize their ESG investment beliefs. Such limits, targets or standards could, for example, include:

- Overall portfolio limits on exposure to carbon or green house gas emissions.
- Targets for investment in "green" assets.
- Standards of materiality for deciding how ESG factors may affect the investment performance of particular assets or sectors.
- Standards relating to executive compensation, diversity, equity and inclusion, labour and cybersecurity practices.

As with any investment strategy, the same obligations apply for plan administrators to periodically monitor and evaluate their ESG investment beliefs and resulting investment strategies against their expected outcomes as well as alternative strategies. The nature of many ESG considerations – which may be constantly evolving, difficult to quantify, point to issues with effect over long-term time horizons and/or based on modelling assumptions – underscores the importance of on-going monitoring and evaluation for demonstrating investment prudence.

How ESG considerations are incorporated into investment decision-making will depend on the unique characteristics of each plan, including its size and the extent of investment management delegation to third parties. The costs of implementing strategies based on ESG considerations need to be understood and included in the overall analysis of the strategy based on a risk-adjusted return, net of fees, basis.

### 3.3.2. Prudent Delegation and ESG Integration

To the extent that a plan administrator delegates investment management to a third-party investment manager or manager of managers (e.g., an “OCIO” provider), the plan administrator should consider whether and how ESG considerations are integrated into the investment decision-making process of any third-party managers and the extent to which that may affect the financial performance of the plan. Plan administrators should supervise this in a manner consistent with their responsibilities under CAPSA Guidelines No. 4 and No. 6 relating to the selection and monitoring of delegates.

### 3.3.3. Stewardship

Stewardship is part of prudent investment decision making, as described more generally in CAPSA Guideline No. 6 (Prudent Investment Practices). The nature of ESG issues often creates opportunities for plan administrators to engage directly, or indirectly, in stewardship as part of their investment decision-making.

Stewardship with respect to ESG issues may involve a plan administrator seeking to use their position as owners or creditors to influence the activity or behavior of investee companies, assets, investment managers, OCIO or other market participants in ways that reflect the plan administrator’s view as to how ESG factors may impact investment performance. ESG-related stewardship activities may therefore include but are not limited to:

- Engagement with investee companies (for both current and potential investees).
- Voting at shareholder meetings.
- Filing of shareholder resolutions/proposals.
- Direct roles on investee boards and board committees.
- Negotiation with and monitoring of the stewardship actions of suppliers in the investment chain.

- Engagement with policymakers and standard setting organizations (e.g., for ESG accounting standards, transition finance taxonomies).
- Contributions to public goods (such as research) and public discourse (such as media) that support financial stewardship goals or improve stewardship approaches.
- And, where necessary, litigation.

For public equity investments, stewardship expectations are often reflected in a set of voting principles/policies. By documenting their approach to voting (e.g., in developing their own proxy voting principles and/or adopting the proxy voting guidelines of their investment managers), plan administrators can facilitate discipline in their voting activities and provide transparency to plan stakeholders.

As a prudent fiduciary, when considering the plan's approach to ESG-related stewardship, the plan administrator should consider:

- Whether and how effective stewardship with respect to ESG can contribute to value creation for the plan, keeping in mind any relevant characteristics of ESG factors (e.g., longer time horizons, complexity, disclosure limitations).
- What constitutes an appropriate stewardship approach for the plan given its investment strategy, fund structure, size, and other circumstances.
- Whether stewardship can be performed on a cost-effective basis including whether plan administrators might benefit from collective stewardship activities such as industry organizations and third-party ratings and shareholder services that specifically consider ESG factors.
- The appropriate level of disclosure to provide to plan stakeholders about the plan's stewardship activities, such as in the plan's SIPP or another standalone policy.

For plans relying on third-party investment managers to integrate ESG stewardship considerations into the plan's investment activities (including member-directed investments), principles for prudent delegation apply, including to:

- Articulate and document the plan's ESG stewardship expectations in the service-provider agreement.
- Work to encourage a robust and transparent process by investment managers.
- Monitor the effectiveness of delivery over time.

In order to support transparency around ESG factors and the plan's investment activities, plan administrators may want to consider reporting on their engagement activities to members and should request companies that they invest in to disclose their ESG policies.

# 4. DISCLOSURE

Principle 3: Pension plan administrators should disclose in their SIPP, information about the pension fund's investment policies in relation to ESG considerations. Where appropriate, pension plan administrators should also provide reports on their stewardship activities as well as request companies in which they invest to disclose their ESG-related policies.

Relevant stakeholders (e.g., members, plan sponsors/employers and unions) have an interest in how plans identify and respond to relevant risks and opportunities, and therefore have an interest in being able to clearly determine whether and how ESG factors are considered in governance, risk management and investment decision-making practices.

Pension standards legislation in all jurisdictions requires the SIPP to include a description of factors relevant to investment policies and procedures. Accordingly, if the plan administrator takes ESG factors into account for purposes of assessing investment risk or opportunity, it is best practice to acknowledge that fact in the SIPP, describe how those factors are considered, and make reference to that information in plan member statements or other sources of plan member information (e.g., websites). Disclosure of ESG considerations may be a regulatory requirement in some jurisdictions.

If ESG factors are considered for risk management and investment purposes, best practice suggests the plan administrator make the following minimum disclosures in describing how ESG factors are considered:

- The roles and responsibilities of the administrator or its agents in identifying and applying ESG considerations.
- The materiality and relevance of specific ESG considerations to the purposes of the plan.
- Any material attribution of ESG considerations to the assessment of risk and performance results.
- Any stewardship activities undertaken.

If the plan administrator relies on a third-party investment manager to take ESG factors into account in managing plan assets, the plan administrator can provide transparency by referencing its adoption of the manager's ESG policy, or describing the plan administrator's considerations with respect to ESG in its selection, ongoing supervision and review of the manager.

If a DC plan's investment line-up includes an "ESG fund", the plan administrator can demonstrate prudence by describing the rationale for the selection of the ESG fund(s) and providing sufficient information for plan members to understand the risk/return characteristics of the fund and how the fund can be incorporated into an investment portfolio from among the investment options in the plan line-up.

Plan administrators are encouraged to ensure that they are keeping pace with disclosure developments and industry best practices, including industry specific guidelines or recommendations for pension funds set out by organizations such as the International Sustainability Standards Board (ISSB) and the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). Given the elevation of climate change as a potential systemic risk to markets, the corresponding increase in demand for relevant disclosure, and the growing international shift toward mandatory climate-related disclosure, plan administrators can look to these developments and practices for ways to demonstrate their standard of care in a manner that is consistent with the scale and complexity of their pension plans.