Recent ESG Developments

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United States Department of Labor

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Plan Fiduciaries

- Required to meet duties of prudence and loyalty
  - Must act solely in the interest of participants and beneficiaries
- Obligation to focus on *material* risk-reward factors rather than other unrelated objectives
- The Department has issued varying guidance addressing these duties over the years but has consistently required that economic risks and returns be the primary consideration

Regulatory Guidance

- Prior Administration
  - In November 2020, the Department published a final rule requiring fiduciaries to invest based *solely* on pecuniary factors
- Current Administration
  - On Day 1 of his Administration, President Biden directed the Department to reexamine its final rule
  - In October 2021, the Department proposed changed to its rules
  - A final rule is currently in the final stages of clearance before publication

Market Trends

Global Sustainable Funds' Asset Size by Region, in billions (2021)

Source: Morningstar data

Market Trends

- In 2022, 75% of Sovereign Wealth Funds and 47% of Central Banks have a formal ESG policy
  - Up from 46% and 11% in 2017

- ESG assets currently make up the fastest growing segment of the global financial services industry

ESG Fund Ratings

- Ratings are important to fund managers
  - A recent survey showed that 70 percent of ESG fund managers rely on sustainability ratings to evaluate performance
- Accurate information is critical
  - Company disclosures on ESG issues are voluntary and, even when issued, may not include all relevant information
  - To mitigate missing information in voluntary disclosures, ESG rating agencies and investment professionals have begun to utilize alternative data and artificial intelligence
  - ESG rating providers have improved their methods and transparency in recent years, and have every incentive to continue getting better as the industry and its tools evolve over time

Major ESG Rating Providers

- Different firms apply different measurements, scope, and weighting methods to produce their ESG scores
  - Morgan Stanley Capital International (MSCI) publishes ratings and research on over 14,000 equity and fixed income issuers rules
  - Morningstar’s Sustainaliyics offers data on 40,000 companies worldwide and ratings on 20,000 companies in over 170 countries
  - Bloomberg offers ESG data for more than 11,800 companies in over 100 countries, organized into 2,000 fields
  - FTSE Russell include 7,200 securities in 47 markets and rate funds based on thematic exposures related to ESG factors

ESG Rating Providers’ Methodology

- MSCI
  - Assigns percentage rates to each ESG risk, according to internal assessments of time horizon and impact
  - The scores are then combined and normalized relative to industry peers to achieve the overall ESG rating ranging from AAA to CCC
- Sustainaliyics
  - Applies a two-dimensional materiality framework to determine (1) industry-specific material ESG risks and (2) how well a company is managing its material ESG risks
  - Places companies in one of five risk categories, comparable across sectors: Negligible, Low, Medium, High, or Severe

ESG Rating Providers' Methodology

- Bloomberg
  - Scores each company's E, S, and G factors separately, using its own industry-specific materiality scheme
  - Applies the EU Taxonomy alignment and Sustainable Finance Disclosure Regulation as a means to combat greenwashing
- FTSE Russell
  - Scores company management risks using a data model that rates companies based on 14 themes that fall under the three ESG pillars and aligns with UN's 17 Sustainable Development Goals
  - Uses an exposure-weighted average to apply greater weight to the most material ESG issues when determining a company's score

Financial Education (Fiduciaries)

- ESG investing is relatively new for DC plans
- Plan sponsors may need to rely on experts in determining how to incorporate ESG
- Key decisions include whether to add ESG investment options and how to assess ESG factors in ESG investments
- The Department has an important role in assisting and educating plan sponsors

Financial Education (Participants)

- While many are interested in ESG, education gaps remain
- A recent study showed 54% were unfamiliar with ESG
- 35% were not interested in ESG investments
    - More than half indicated they did not understand ESG investments well enough
- 26% held some type of ESG investment
- 46% indicated they would be interested in ESG investments

Challenges for retirement investors

- Definitional issues
- Ratings agency methodology
- Greenwashing
- Complexity and friction for small and medium schemes

Conclusion

- Despite some growing pains, it is clear ESG investing will be a permanent, ever-evolving part of the pension landscape
- New regulatory standards, increased transparency, and enhanced reporting capabilities are emerging
  - These changes will benefit plan sponsors as they consider ESG investing within their plan's overall investment framework, and ultimately help them fulfill their fiduciary duties.