ESG in Retirement Plans:
Investment, Risk Management and Regulatory Considerations

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Both defined benefit and defined contribution retirement plans are increasingly integrating environmental, social and governance (ESG) considerations into their investment approaches. This article reviews ESG trends and describes the challenges, policy debates and regulatory changes.

The Rise of Environmental, Social and Governance (ESG) Investing

ESG is arguably the most frequently used acronym within investment marketplace discussions today. According to one report, mentions of ESG (environmental, social and governance) and a related term, *sustainable finance,* grew by more than 50% in major media outlets in 2021 while mentions of the term *climate transition* rose by more than 135%.[1] NASDAQ, the second largest stock exchange in the United States, reported that 65% of corporate securities issuers used ESG in their quarterly earnings calls during the first quarter of 2022.[2] In contrast, asset manager PIMCO reported that ESG was mentioned in fewer than 1% of earnings calls between May 2005 and May 2018.[3] As one NASDAQ strategist explained, "ESG is almost a fallback point for companies to explain how they are preparing for long-term value creation via nonfinancial risks and opportunities."[4]

ESG Defined

ESG refers to the use of metrics and qualitative data on environmental, social and governance matters that inform the assessment of an asset. Considerations may include whether an asset has a lower risk exposure or the potential for a superior gain because of (1) an environmental impact, such as reduced water use; (2) a social impact, such as positive labor relations; or (3) a governance factor, such as stronger shareholder rights that keep a company's board of directors more accountable to shareholders. *ESG integration* means that an investment manager incorporates ESG data, along with traditional financial metrics, in the investment management process to enhance risk-adjusted returns. While an ESG-dedicated strategy portfolio contains stocks or other securities that pass a certain ESG bar, ESG integration is a more general approach—There is no inherent bar that stocks or other asset classes must surpass, but asset selection and management may be better informed by considering ESG data alongside traditional financial characteristics. Most asset managers today use ESG integration in their approach, particularly with respect to the quality of governance of an investment.

ESG Assets Under Management

Led by investor demand, ESG incorporation by money managers has risen sharply in the past decade and a half. Total U.S. assets under management that considered ESG factors grew from $178 billion in 2005 to $17.1 trillion in 2020, according to the *Report on U.S. Sustainable Investing Trends* issued by the U.S. Forum for Sustainable and Responsible Investment (US SIF). Consultancy PwC projected that ESG-oriented assets under management in the U.S. would more than double from $4.5 trillion in 2021 to $10.5 trillion in 2026.[5] As further evidence of ESG incorporation, a 2017 CFA Institute survey found that 73% of respondents considered ESG criteria in investment decision making and analysis. Despite the mainstreaming of ESG, some states are passing laws and guidance intended to have a chilling effect on ESG integration by public sector plans, as discussed in more depth below.

ESG Incorporation in Retirement Plans

U.S. defined benefit (DB) pension plans, which held $10.5 trillion as of the second quarter of 2022, have historically incorporated ESG at a faster pace than have defined contribution (DC) plans. One explanation is that larger DB plans can invest in equities more frequently through separate accounts that hold individual securities, whereas DC plans often invest in pooled funds, such as mutual funds. Separate accounts give plan sponsors control over proxy voting and the submission of shareholder proposals because they own corporate stock directly. In a pooled fund, the investment manager owns the underlying stocks and, therefore, controls the proxy voting and submission of shareholder proposals. As of the second quarter of 2022, 63% of the nation's $6.5 trillion in 401(k) plan assets were held in mutual funds, effectively ceding proxy voting as a tool of ESG to investment managers for the portion of plan assets invested in equities.[6]

However, this pattern is likely to shift. The Department of Labor's (DOL's) recent rulemaking on proxy voting and ESG requires investment managers of pooled funds, including mutual funds that do not enable plan sponsors to hold individual securities, to vote proxies in proportion to each investor's economic interest in the fund or require participating investors to accept the investment managers' proxy voting policy prior to investing.[7] All provisions of the new rule will be in effect by December 1, 2023. In addition, BlackRock, the world's largest investment manager, in 2022 announced that it will allow investors in pooled funds to vote their proportional stake in portfolio companies. State Street Global Advisors has followed suit.[8] If additional index and commingled fund investment managers join this trend, this would represent an expanded opportunity for both DB and DC plans to integrate ESG in a manner that is consistent with traditional fiduciary obligations.

takeaways

- Environmental, social and governance (ESG) considerations for investing may include whether an asset has the potential to contribute to (1) an environmental goal, such as clean water; (2) a social goal, such as labor relations; or (3) whether the asset's corporate governance has the potential to enhance shareholder value.
- Institutional investors are increasingly using ESG considerations as the global economy and risk environment changes.
- *ESG integration* means that an investment manager incorporates ESG data, along with traditional financial metrics, in the investment management process to enhance risk-adjusted returns.
- U.S. defined benefit (DB) pension plans have historically incorporated ESG at a faster pace than have defined contribution (DC) plans.
- Public pensions in some regions of the country may face a challenge when incorporating ESG considerations because of recent state proposals to restrict or define their use of ESG factors. Recent federal regulations, however, have been supportive of the concept of ESG integration.
- ESG integration may be viewed as a set of mechanisms within a larger risk management framework.

ESG Adoption Mechanisms

In considering ESG adoption, retirement plan sponsors arguably have four mechanisms for implementation at their disposal:

1. Adoption of investment policy provisions that document ESG criteria
2. Inclusion of ESG considerations in selecting investment managers, assets or securities
3. Proxy voting
4. Shareholder engagement.

ESG adoption through the investment policy may take a range of forms, including a plan sponsor's inclusion of

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a basic provision citing the fact that trustees may consider ESG factors in making investment decisions where such consideration is in the best economic interest of plan participants. The pragmatic inclusion of ESG considerations, along with traditional criteria, is becoming the norm for investment consultants who recommend investment managers to their clients based on structured due diligence processes, as well as for asset managers who construct portfolios of equity securities or hard assets (e.g., real estate).

Proxy voting and shareholder engagement enable investors in public equities to advocate for a company's adoption of proposals that may improve shareholder value through the company's policies and practices on ESG issues that are valued by financial markets.

While data vary on incorporation through these mechanisms, the following findings are evidence for increasing adoption as well as a wide range of conclusions about the current state of play in plan types and asset classes. Some investors and specialty mutual funds employ divestment from investing in a security, asset class or industry in applying ESG factors; however, this is not an approach supported by DOL regulations and is more common among endowments, foundations and mission-driven investors (e.g., nonprofits).

Defined Benefit Plans

Among DB plans, ESG incorporation varies with regard to size and sector, with larger public and multiemployer plans having the highest level of adoption and smaller plans and single employer corporate plans likely having a lower level of adoption. Across the global investment landscape, pension plans in Europe, Canada and Australia have long considered ESG factors, as evidenced by the following trends.

- U.S. public pension funds reportedly accounted for 54% of the $6.2 trillion in institutional investor assets that incorporated ESG, according to the 2020 US SIF Foundation survey.
- In Europe, consultants estimate that 89% of pension funds take ESG risks into account in their investment approaches.
- According to a 2020 study, 16 of 74 U.S. public funds, or 22%, mentioned ESG in their publicly available documents, while other surveys indicate a higher level of incorporation.
- A survey cited in *Pensions & Investments* found that investors are incorporating ESG beyond public equities into fixed income (60%), real estate (43%) and infrastructure investment decisions.

Defined Contribution Plans

While DC plans may integrate ESG through a range of mechanisms, a common approach is to offer a dedicated ESG or socially responsible option under the plan's investment menu. Whatever the approach, the following statistics paint a picture of a slower, but accelerating, ESG adoption rate.

- In 2018, PRI reported that between 2% and 8% of DC plans offered ESG investment options.
- In 2020, Morningstar reported that while only 4.5% of DC plans offered a sustainable (ESG) option, 22% are incorporating ESG factors into their traditional options.
- A survey from asset management firm PGIM found that 24% of plan sponsors indicate that they have taken action to incorporate ESG into their plans over the last three years, while 52% said they had not.

ESG Integration by Delegation

A recent report cited a reduction in institutional investors' use of ESG factors in investment decision making;[9] however, the study likely overlooked the fact that plan sponsors often implicitly delegate ESG factor consideration to their investment managers and investment consultants rather than making ESG assessments in house. The uptake of ESG integration through delegation is evidenced by the following.

- In a recent survey, 68%, 57% and 43% of investment consultants reported that they require investment managers to report on ESG practices, proxy voting, and diversity and inclusion, respectively.[10]
- In the same survey, 64% of U.S. investment managers reported using ESG principles in their investment decision-making process, and 79% globally reported

employing investment managers who incorporate ESG factors into the portfolio management process.
- Although precise data is not available, public and multiemployer DB plans, in particular, have long invested in real estate funds that demonstrate fair labor practices and use of union labor and signatory contractors as well as energy sustainability under the DOL's "all things being equal" principle.

Implementation in a Fiduciary and Risk Management Framework

Link Between ESG and Risk-Adjusted Investment Performance

Although research has shown varying conclusions, studies generally find a positive correlation between ESG incorporation and financial performance. For example, a frequently cited report by the NYU Stern School for Sustainable Business noted that 59% of 245 studies on the topic from 2016 to 2020 found either a neutral or positive impact on investment and risk measures, including alpha and the Sharpe ratio.[11] The study also found a higher correlation between ESG integration and performance, where the asset is held in the portfolio, than for negative screening, where the portfolio excludes certain securities or industries.

A 2021 CFA Institute survey found that 79% of respondents believe investment managers should either always integrate ESG regardless of circumstances or integrate when ESG factors are deemed financially material. Only 18% stated that ESG integration was not necessary.[12] Finally, the RBC *Responsible Investment Survey* found that majorities of respondents, 57% and 52%, respectively, were incorporating ESG to conform to fiduciary responsibility and to lower risk and/or increase returns.[13]

According to a PwC report, approximately 90% of investment managers surveyed globally believed that ESG integration would improve returns, while 60% of institutional investors worldwide, which include pension funds, reported that ESG integration had already boosted returns compared with investments that do not integrate ESG.[14]

ESG Role in a Risk Management Framework

Many fiduciaries and risk management experts view the application of ESG analysis as a necessary process to measure risk that should be included in a larger risk management framework that evaluates risk both internal and external to the investment portfolio as risk exposures change over time. For example, private real estate investment managers have typically reported on measures such as property type diversification, occupancy and leverage to inform clients of the risk embedded in a diversified real estate portfolio. Today, in addition to reporting on these traditional risk measures, real estate managers for ERISA-governed and public pension plans also typically include ESG measures, such as the real estate portfolio's Global Real Estate Sustainability Benchmark (GRESB) score, as a measure of the portfolio's ESG performance and risk (a low score would indicate higher risk).[15] A simplistic example of how ESG factors indicate risk is to consider a manufacturer based in a coastal area that frequently experiences severe storms. If the manufacturer is not considering how a hurricane would impact its physical plant, the risk of catastrophe that would be detrimental to the value of the asset is greater.

Challenges, Policy Debates and Regulatory Developments

Notwithstanding the alignment of a pragmatic approach to ESG with a plan's fiduciary obligations, ESG faces challenges ranging from legislative proposals in opposition to ESG in some states to the need for a more mature and standard set of measures.

Legislative or Agency Proposals Challenging ESG

In the past several years, public officials in a number of states have proposed initiatives or rules that would restrict public pension plans' use of ESG factors. Examples include the following.[16]

- In July 2022, the governor of Florida announced proposals that would prohibit the Florida State Board of Administration (SBA), which administers the state pension fund, from considering ESG factors in a manner that subordinates pecuniary factors.
- The Texas State Comptroller announced plans to implement a 2021 state law that restricts state agencies from investing in companies that boycott energy companies.
- In March 2022, Idaho's governor signed the Disfavored State Investments Act, which pertains to public entities' consideration of ESG.
- As evidence of legislation seeking to make ESG more expansive to the point of taking away a fiduciary's flexibility, in June 2021, the state of Maine signed a law re-

quiring that the state retirement system stop investing in fossil fuel companies.

More recently, the following challenges to ESG investing, among others, have been introduced at the federal and state levels in 2023, as well as within the asset management industry.

- The U.S. Senate and House of Representatives passed a resolution that would nullify DOL regulations governing ESG investing in retirement plans. (President Biden vetoed the legislation on March 20, 2023.)[17]
- Vanguard, which reportedly manages over $7 trillion in global assets, announced in December 2022 that it would withdraw from the Net Zero Asset managers initiative, an international group of asset managers that support the goal of net zero greenhouse gas emissions by 2050 or sooner.[18]
- As of February 2023, up to 16 states were expected to introduce legislation that will pose additional challenges to ESG investing.[19]

These developments will require public retirement plans and asset managers to actively monitor developments in these jurisdictions and elsewhere.

Regulatory Developments

At the federal level, despite the above-cited challenges, recent regulations have been supportive of the concept of ESG integration where the process is aligned to the economic best interests of plan participants. On November 22, 2022, after suspending less supportive regulations enacted under the previous presidential administration, the DOL published a new rule on ESG and proxy voting that:

- Reiterates plans' voting proxies as a core fiduciary responsibility for retirement plans
- Requires fiduciaries to rely on risk-return factors regardless of whether they are ESG factors
- Reinstates ESG considerations as the tie-breaker when deciding between similar investment options.

Given that regulations may change materially with a change in U.S. presidential administrations, it is important for plan sponsors to consult with their counsel and investment advisors

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regarding the impact of potential regulatory changes on the plans' practices.

While public plans are not governed by ERISA, many use ERISA provisions as a model. Therefore, the new DOL rule is likely to impact market trends in support of ESG across retirement plan markets. Again, plan sponsors should review the implications of regulatory changes with their counsel and investment advisor.

Challenges: Measures, Metrics and Terminology

One of the challenges that ESG faces is the multitude of factors, definitions and measures that fall within its purview. For example, the following are notable challenges.

- The *ESG and Financial Performance* report noted that research on ESG often "suffers from inconsistent terminology" and cites as one example a study that noted 33 definitions of corporate sustainability in usage.[20]
- Critics claim that imprecise terminology was a contributing factor to allegations of *greenwashing,* or making misleading claims of environmental impacts, among several investment managers that have been the subject of investigations launched by the Securities and Exchange Commission (SEC) and regulators in Germany.
- Some observers point out that geopolitical developments can pit the E, S and G of ESG against one another, as evidenced by European governments' suspension of environmental goals to reduce reliance on Russian natural gas for ethical reasons.[21]

To help address challenges in measures, many plan sponsors correctly use their position as fiduciaries to require that their investment advisors and investment managers review measures with plan trustees periodically with a focus on efforts to standardize measures in a manner that supports consistency in decision making.

Conclusion

Notwithstanding challenges, institutional investors, including retirement plans, are increasingly integrating ESG considerations pragmatically as the global economy and risk environment changes. ESG integration may be viewed as a risk management tool that the plan may apply through a series of mechanisms, including long-established practices such as corporate governance and proxy voting.

Editor's note: The status of environmental, social and governance investing legislation and regulations was current at the time of writing but continues to evolve.

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