Principles for Responsible Investment

WORKING TOWARDS A SUSTAINABLE FINANCIAL SYSTEM:

# INVESTMENT CONSULTANT SERVICES REVIEW

FINANCE UNEP INITIATIVE

United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

# THE SIX PRINCIPLES

## PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.


## PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

With thanks to: IC Research Institute

# EXECUTIVE SUMMARY

Investment consultants advise on the investment practices of trillions of dollars worldwide. They are a recognised source of authority and knowledge. However, most consultants and their asset owner clients are failing to consider environmental, social and governance (ESG) issues in investment practice – despite a growing evidence base that demonstrates the financial materiality of ESG issues to portfolio value. There currently seems little commercial imperative for investment consultants to extend the coverage of ESG integrated services among their clients. Nor do we see pension schemes demanding ESG integrated services from their consultants. In too many cases, consultants and their clients simply don't talk about ESG issues.

Neglecting ESG issues can lead to asset owners mispricing risk and making poor investment decisions. This is why effectively managing ESG issues is a core part of the fiduciary duties owed by asset owners to their beneficiaries. Investment consultants need to ensure that their asset owner clients navigate these challenges effectively if they are to retain their position as trusted advisers and if they are to grow and develop their future businesses, for example, in fiduciary management.

The PRI believes the full suite of investment consultants' service delivery should be reviewed from an ESG perspective. Our aim is that this research drives a deeper discussion in the industry about the inclusion of ESG issues as a standard part of consulting advice and which new or additional ESG integrated investment services are needed. We will continue to review:

- Investment strategies and beliefs – The way that consultants and their clients publish investment strategies and beliefs, implement investment beliefs throughout the organisation and include ESG performance as a standard agenda item at performance review meetings.
- Asset allocation and portfolio construction – The way ESG risks and opportunities can be integrated into funding assumptions, asset allocation and portfolio construction, and how the service offering needs to evolve.
- Fund ratings – Inclusion of ESG questions in due diligence questionnaires and assessment of responses. All clients should be presented with ESG fund options.
- Reporting – Client reporting and inclusion of ESG performance reporting as standard.
- Fiduciary management – Full incorporation of ESG issues in fiduciary management, including in stock or fund selection, stewardship and active ownership, voting and reporting.
- Potential new ESG integrated services to ensure provision of adequate ESG-related investment advice.

This shift is unlikely to occur without intervention. There are many barriers in market structure, industry practice, and policy and regulation that need to be overcome. Without addressing these barriers there will be little change in the advice provided by investment consultants.

The report sets out these barriers in detail and identifies a set of preliminary interventions that the PRI will develop over the coming months. Broadly, these ideas area:

- Improving incentives from asset owners – Enable small to medium and resource constrained asset owners to pool and clearly express their ESG service demands, develop quality standards and provide guidance on fiduciary management.
- Further developing investment practices – Develop ESG investment beliefs, assist investment consultants to develop more advanced ESG integrated services, publish guidance for asset owners on how to identify, select, appoint and monitor investment consultants and enable industry-wide expertise on ESG issues.
- Changing the policy and regulatory framework for investment consultants – Extend the PRI's and UNEP FI's fiduciary duty programme to investment consultants, work with professional bodies to incorporate ESG issues within regulation, support policy interventions to increase pension scheme pooling and put sustainability at the core of financial regulation.

We are now undertaking a consultation of asset owners and investment consultants to develop and extend the solution set and we welcome feedback, which can be sent to policy@unpri.org.

The PRI's Blueprint for Responsible Investment calls for investors to address barriers to a sustainable financial system. A sustainable financial system is one that contributes to environmentally sustainable, equitable economies and ultimately a more prosperous world for all. The influence of brokers, rating agencies, advisors and consultants on investment decisions, was identified in the PRI's analysis and signatory consultation as one of nine key areas requiring reform. This report is the first of the PRI's reports examining the role of investment consultants in the financial system.

For more information on the PRI's financial system activities see www.unpri.org/sfs

# INTRODUCTION

Investment consultants are the primary point of contact for many asset owners in the investment market. This is particularly true in the US, UK and Japan. Consultants provide a range of advisory services to asset owners, from funding decisions, to asset allocation, manager selection and reporting processes. They frequently train sponsors and trustees on approaches to investment and emerging investment trends. They are a recognised source of authority and knowledge on investment practice. Their advice shapes the beliefs and practices of trillions of dollars of invested assets worldwide. The views that investment consultants hold about ESG factors have major implications for the sustainability of the financial system.

## ABOUT THIS REPORT

This report is the first output from the PRI's programme of work on investment consultants[1]. The primary audience are asset owners and investment consultants. They, through the client-adviser relationship, define the range and scope of services and advice, including the emphasis placed on ESG issues in this advice. Our findings are also relevant for policy makers and regulators.

The report identifies barriers relating to market structure, industry practice and policy and regulation in the consulting market. These barriers are leading to failures in the service quality given to investors. We discuss how asset owners can encourage investment consultants to better integrate ESG issues into their advice. We also discuss the barriers to investment consultants offering more integrated advice. This includes barriers on the demand (i.e. asset owner) side, on the supply (i.e. investment consultant) side and within the wider regulatory and policy framework that asset owners and investment consultants operate. We conclude by suggesting actions that could be taken to overcome these barriers.

The report is based on interviews with 22 investment consulting firms and industry experts, data from the PRI's Reporting and Assessment framework[2], data on investment consultants, their clients, philosophies and staff provided by IC Research Institute[3], and a review of the academic and practitioner literature on investment consultants and their clients. Interviews included both ESG-specialist consultants and field consultants.

The primary geographic focus of this research was the US, UK and Australia[4]. However, the general analysis and conclusions are relevant to all markets where asset owners rely on advice from investment consultants. The research also draws on the PRI and UNEP FI's fiduciary duty programme, which has covered 14 markets[5].

**Location of consultants. Source: IC Research Institute**

| | Staff location | Number of consultants |
|---|---|---|
| 1 | USA | 6,380 |
| 2 | UK | 3,559 |
| 3 | Australia | 535 |
| 4 | Canada | 452 |
| 5 | Germany | 315 |
| 6 | Switzerland | 313 |
| 7 | Netherlands | 298 |
| 8 | South Africa | 262 |
| 9 | France | 209 |
| 10 | Ireland | 147 |
| 11 | Singapore | 111 |
| 12 | Hong Kong | 108 |

1 See further https://www.unpri.org/news/pri-sets-out-nine-priority-conditions-to-address-in-sustainable-financial-system-work and, more generally, PRI's Blueprint for Responsible Investment, https://blueprint.unpri.org/

2 https://www.unpri.org/report/reporting-for-service-providers

3 http://www.ic-research.org/

4 These are markets where investment consultants are widely used.

5 www.fiduciaryduty21.org

# THE LANDSCAPE OF INVESTMENT CONSULTING AND A SUSTAINABLE FINANCIAL SYSTEM

Investment consultants help asset owners by:

- Streamlining their manager research and appointment processes, thereby reducing costs
- Providing asset owners with access to advanced technical expertise and investment research
- Helping asset owners to build their capacity and expertise on investment issues
- Understanding and interpreting the information provided by asset managers.

However, investment consultants provide little advice on implementing responsible investment, integrating ESG issues into investment research and decision-making, or on monitoring the ESG performance of asset managers. Despite pockets of excellence and some high profile projects on issues such as climate change and long-term investment, ESG considerations are not a standard part of the advice offered by investment consultants. **They are widely seen as niche service offerings, often entailing extra costs, and only to be provided when explicitly requested by asset owner clients.**

**Neglecting ESG issues can lead to asset owners mispricing risk and making poor investment decisions. In turn this can undermine their short, medium and long-term investment returns**. Effectively managing ESG issues is a core part of the duties owed by asset owners to their beneficiaries and to wider society[6]. If investment consultants are to retain their position as trusted advisors, and develop their future businesses (e.g. fiduciary management), they need to ensure that their asset owner clients navigate these challenges effectively.

6 See, for example, PRI's work on fiduciary duty, http://www.fiduciaryduty21.org/

# THE BARRIERS TO ACTION

Our research suggests that **the barriers preventing investment consultants from better incorporating ESG into their advice can be grouped into three broad categories relating to:**

- **Market structure**
- **Industry practice**
- **Policy and regulation.**

All are related and we see many examples of the issues interacting with each other to create seemingly insurmountable barriers to progress.

## MARKET STRUCTURE

Relationships between asset owners and investment consultants have a major influence on whether and how investment consultants take account of ESG issues in the advice that they provide. Issues on both the supply and demand side of the market can contribute to a weak take-up of ESG: **Fragmented demand side markets with relatively low buyer power and concentrated supply side with relatively low incentive to innovate services**.

### DEMAND SIDE

Large well-resourced asset owners, endowments, and private wealth funds with strong commitments to responsible investment, have been able to demand that their investment consultants provide them with high quality ESG-related research and analysis. In these situations where the individual client has power or influence, investment consultants will tend to meet the client's ESG requirements.

However, **asset owners are mostly offered a relatively modest service in terms of ESG issues**. When making fund or fund manager recommendations, consultants may ask questions of their clients about the importance of ESG issues in their investment beliefs and about the weight they should be assigned. Our research however suggests that most, but not all, consultants include questions about ESG issues in their fund manager due diligence processes. These are often optional, pitched at a high level, and not scrutinised with the same level of attention as other investment-related questions. Payment of additional service fees is generally required if asset owners require a more comprehensive service.

The details of the services offered by consultants are strongly influenced by the structure of national or regional investment markets. In markets where savings are concentrated in a smaller number of larger entities and where ESG issues are considered to be an important part of the investment process (e.g. Australia), there is greater pressure on investment consultants to develop their capacity and expertise on ESG issues and to proactively offer this to clients.

Conversely, in markets with a large number of small schemes, such as the UK, asset owners' ability to demand ESG-related advice from investment consultants tends to be limited. The investment consultant interviewees for our research noted that, in these markets, they are rarely asked about their beliefs on ESG issues or the advice and support they can offer regarding them. From this consultants conclude that ESG issues are not important to their clients and there is less need for them to expand their capabilities and expertise on these issues. In turn this can mean that investment consultants are unwilling to raise ESG-related questions with their clients due to their lack of capacity or competency to respond on these issues.

> "We try to nudge them along, but the power resides with the investor. It is very much the case of trying to understand what the client's investment objectives are. No strategy is 'off-the-table'."

Finally, few asset owners globally have made commitments to responsible investment or to fully consider ESG issues in their investment process. Interviewees from global investment consulting firms noted that, across their business as a whole, ESG advice comprises a very small proportion of their fee income. This further reinforces the perception that ESG is an add-on to the products and services that are demanded by the market.

## SUPPLY SIDE

**The investment consulting market is concentrated**[7]. It is dominated by firms such as Aon Hewitt, Callan Associates, Cambridge Associates, Mercer, NEPC, Russell Investments and Willis Towers Watson. A relatively small number of investment consultants have come to dominate the market for various reasons:

- Their recognised investment expertise
- Their understanding of asset owners' needs and interests
- Their ability to provide cost-effective access to information on a large range of investment managers and investment strategies – This is seen by asset owners as a unique competency of investment consultants and as such a key service offering
- Their credibility and reputation which allows asset owners to rely on advice provided by investment consultants to justify the decisions that they have made
- Their ability to offer a wide range of investment-related services and advice under a single company banner through the one or two consultants that work with individual clients.

These characteristics – which can be summarised as investment consultants offering what are seen as core products and services to their clients – represent important barriers to entry for new firms with new or different ideas or products. **Asset owners are reluctant to work with investment consultants who have a less comprehensive coverage of asset managers**. If asset owners do decide to move beyond the largest global firms, they tend to confine their work with these consultants to niche, specialist areas. These new firms are then unable to effectively break into the larger investment consulting market. Compounding these barriers to entry is the fact that investment consulting is a relationship orientated industry. Asset owners tend to develop strong relationships with investment consulting firms and with individuals within those firms.

> "Outsource CIO is a scalable business, rather than advice."

Together, these factors mean that **the large investment consultants have established a strong position as expert and trusted advisers to asset owners, and asset owners have tended to stay with the same investment consultants for long periods of time** (i.e. switching rates appear low)[8].

A further issue is that, as employers move away from offering defined benefit (DB) schemes, investment consulting is now seen as a declining industry. This does not mean that it is unprofitable. Nor does it mean that investment consultants will cease to exist in a few years. However it does mean that investment consultants may be less willing to invest in what they see as a sunset business, or to develop new or innovative services, in particular (such as in the case of ESG) where it is not clear that these services will lead to a growth in fees or new business opportunities. Compounding this lack of incentive to innovate are the main points of differentiation between consultants; price, the breadth and depth of core services such as asset manager evaluation, and the perceived credibility of the investment consulting firm.

> "On fiduciary management, in general, ESG is likely to be less integrated. Clients are less engaged, less resourced, less interested, less likely to care where the money comes from."

One significant trend in the consulting market is the move towards fiduciary management. This is seeing investment consultants encouraging their clients and other asset owners to move from a consulting relationship to a fiduciary management relationship[9]. This potentially accelerates the decline of the investment consulting market. It may also mean that investment consultants find that they are in commercial relationships with many of the investment managers that they are assessing. From an ESG perspective, it is unclear whether fiduciary management is 'better' or 'worse'. Regardless, what is clear is that the barriers and challenges of the market structure, industry practice and regulation will continue to apply.

7 Financial Conduct Authority (2017), Management Market Study. Final Decision: Market Investigation Reference (MIR) on investment consultancy services and fiduciary management services FCA study, Section 3. https://www.fca.org.uk/publication/market-studies/final-decision-market-investigation-reference.pdf

8 See also Financial Conduct Authority (2017) (Note 6).

9 Fiduciary management is a key growth areas for investment consultants. For example, the FCA in its review of the UK market noted that the total values of assets managed by investment consultants under a fiduciary arrangement had tripled between 2011 and 2015 (Financial Conduct Authority (2017) (Note 6)).

"There are less than a handful of managers out there that are integrating ESG in a meaningful way. Beyond that there are a lot of gimmicky managers saying, 'we can pick up some dollars if we put ESG on our product'. So you end up with a set of lower quality of managers."

## INDUSTRY PRACTICES

The market structure issues discussed above are compounded by consulting practices and processes. The following being of particular importance: Investment beliefs, the relationship between asset owner clients and consultants, internal organisational structures, the costs of providing advice on ESG issues, DB DC risk transfer, the funding assumptions of pension plans and expertise and knowledge gaps.

### INVESTMENT CONSULTANT BELIEFS

**Investment consultants' interpretation of fiduciary duties remains the single biggest barrier to progress**. Our research suggests that the majority of investment consultants are sceptical that a focus on ESG issues can enhance investment performance. Many believe that a focus on ESG issues inevitably involves compromising investment performance. These views influence the advice that is provided to clients (e.g. on their investment beliefs on ESG issues) and the manner in which investment consultants conduct their research on asset allocation and on investment managers.

"We're continuing to review the research both from academics and the industry. Our view is that ESG is a 'do no harm' at worse. We're seeing our clients more open to considering an ESG mandate. However, it still feels like it's early in the innings on evidence."

### FACTOR INVESTING

Factor investing points out that a number of methods of constructing portfolios on the basis of accounting or market data can outperform market-cap indices (either by improving returns or reducing risk).

A number of consultants expressed interest in approaches which combine factor investment with ESG data to create hybrid portfolios.

Factor investing is in its infancy, yet it does open up the possibility of seeing ESG issues as a factor to be incorporated on a quantitative basis into low-cost portfolios.

"There are currently no minimum expectations of field consultants on the extent to which they discuss ESG issues with their clients."

The investment consultants interviewed for our research proposed the following reasons for these perceptions:

- A lack of public commitments on ESG issues made by most consulting firms, or to applying these commitments across all of the advice that they offer[10]. This limits the incentive for individual consultants to raise these issues with their asset owner clients.
- A lack of robust academic evidence proving that a focus on ESG issues can lead to investment outperformance. This is compounded by the practical difficulties associated with assessing the influence of ESG issues and separating them out from quality factors in investment risks and returns.
- Many consultants continue to equate responsible investment with negative screening.

"We don't have a firm-wide view on climate change yet."

10 A recent exception is AMNT / UKSIF's initiative on investment consultants: https://amnt.org/press-release-amntuksif-initative-investment-consultants/ (see below).

- Very little, if anything at all being taught within the education syllabus and qualification processes for key professional exams in the sector (in particular, those for the CFA and for the professional actuarial bodies) about ESG issues. Professionals may spend 3-10 years in training without understanding the importance of ESG issues and be unprepared to bring it to their clients.
- A belief that if ESG issues are important, then investment managers should already be addressing them and that investment performance is the primary measure they should use to analyse how the investment manager is dealing with ESG issues.
- **Consultants see ESG issues as being less relevant to passive managers**, despite the proportion of assets that this sort of manager controls. This behaviour fits into an entrenched world-view of risk and return maximisation whereby a passive index (market-cap-weighted) represents the benchmark of optimal performance, and, crucially, where ESG represents a deviation from that benchmark. An interesting challenge to this is coming in the form of "factor investing".

"It's much less risky to be late to ESG than early – unless you're in California or you're in a family plan or a small investment group where you can get everyone behind you. When you have a diverse constituent base there's an ESG headwind. There's lots of scrutiny across the industry, particularly if there is any hint of undermining returns."

## SERVICE COMPOSITION

**Models that inform funding assumptions do not account for ESG issues** (e.g. in the assumptions and scenarios that are being used to test portfolio resilience). While we did identify two interesting projects, we were unable to find any examples of where the incorporation of ESG issues into modelling had substantially altered asset allocation decisions. Responses showed that most consultants find it hard to understand the relevance of ESG issues to modelling in general. Most said that it would be a long time before ESG issues were incorporated in their modelling. Some felt that it would be undesirable. In most cases the funding discussion only treats investment allocations as broad "equity/bond" type measures. In these cases, the discussion would not set any further detail.

### FUNDING ASSUMPTIONS AND MODELLING

Negotiations and decisions on funding are based around the funding risk. This is broken down by:

- Covenant risk;
- Liability risks (e.g. mortality, inflation);
- Asset-matching risk—primarily investment risks.

In most cases the funding discussion only treats investment allocations as broad "equity/bond" type measures.

Few consultants have considered the relevance of ESG issues to funding assumptions and investment models. Some examples of consultants who produce assumptions which include climate-change impacts were found, including "assumption-setting" models based on the impact of climate change on GDP (for example, we found one example of a 2 degree scenario costing 20 basis points over the base-case).

One firm we interviewed has tools to include the impact of climate change in their assumptions for valuations. However, these were the only two examples we found.

This raises two questions:

1) **Is it desirable for asset owners to receive ESG-aware funding or asset allocation advice?**
2) **Can ESG make a difference to these areas?**

Fundamentally these are strategic areas where risks are managed by the institution itself through funding rates or asset allocation. As noted above, there appears to be little development in this area. Work needs to be undertaken to explore whether existing models can be adapted, or if not, what additional tools or models need to be created in order for asset owners to receive ESG-aware funding or asset allocation advice.

## THE CLIENT-CONSULTANT RELATIONSHIP

**All consulting firms employ a "client comes first" approach**. The process of discovering clients' beliefs and interests is commercially led. Consultants may be reluctant to present ESG ideas to their clients if they do not believe that they generate revenue or they fear weakening their relationship with the client. Our interviews **suggest that consulting firms do not make it a requirement of their field consultants to proactively raise ESG issues with clients**.

## DB DC RISK TRANSFER

The overall trend in global pension provision is of plans switching from DB to DC and entering into de-risking arrangements on their DB plans when their funding position allows.

Reducing the scale of plan deficits and risk transfer often dominates the agenda for scheme governing bodies and their advisers. Deficit discussions can also put strain on the relationship between plans and sponsors. While large unfunded pension liabilities can create a negative market perception of a corporate sponsor's financial health, plugging large deficits will, in most cases, require significant value transfer by the sponsor. This will likely require the waiving of future dividends or taking on greater financial leverage.

The scale of such value transfer and the "notional" nature of deficit computation can make sponsors reluctant to consider ESG products, particularly given ESG products often attract higher fees.

Investment consultants see their role as advisory. While consultants can raise issues with their clients and make suggestions, ultimately it is for their clients to decide how they wish to act. There are also commercial dynamics at play; consultants (both individual consultants concerned about their career risk, and consulting firms as a whole) are reluctant to take actions that may jeopardise their relationship with their clients. This can include a reluctance to raise issues that are not of interest to their clients.

Incumbency can also make it hard to challenge beliefs. Consultants will spend time with new clients to understand their attitudes and views on a range of investment-related issues. They will often ask about ESG issues as part of this process. If the client's initial response is that they are not interested or not aware, consultants rarely revisit this question. Indeed, consultants will research their clients in advance of providing advice. If a client has not made public commitments to ESG issues, consultants may interpret this as a lack of interest and therefore not raise ESG products, without directly asking the question.

## FIRM STRUCTURE

Different consulting firms have adopted different approaches to ESG issues. This includes the appointment of dedicated ESG staff, or "ESG champions" in the business, and/or the integration of ESG into product or service lines. We found little evidence to prove that the quality of ESG-related advice is dependent on firm size or on how ESG advice is structured within the firm.

> "For a DB scheme, we determine the deficit, the covenant, and then determine the appropriate asset mix. For some closed DB pension schemes, close to buy out, advice is often to consider longevity swaps. For other funds, advice is to purchase LDIs to meet known liabilities. In both scenarios, we do not consider ESG."

However, we did find that **clients' ability to access ESG-related information and expertise is critically dependent on the individual consultants who manage the client relationship**. The extent to which ESG issues are raised and discussed with clients is generally at the discretion of the relevant field consultant.

In practice, this means that these consultants see their role as being to respond to the issues and questions raised by the clients. The importance placed on client-led advice means that these consultants are reluctant to raise issues that are not requested by their clients. They tend to provide advice on ESG issues or access to ESG specialists only when this is specifically requested by the client. We were unable to find examples of consulting firms – other than as part of the general process of taking on new clients – requiring their consultants to raise ESG issues with clients. Interviewees for this research also commented that their **organisational statements or commitments on ESG issues are generally perceived as secondary to the implicit or explicit preferences of their clients**.

## FEES

**ESG-related research and advice is often seen as an additional cost to be charged to clients**. This reinforces the perception that it is additional, and not integral to the core advice provided by investment consultants. It also creates a real barrier to asset owner clients requesting or accessing this research and advice. This applies across the whole range of fee models that we see in the investment industry. For example, in fixed fee contracts, asset owners may not include ESG issues in their requests for tenders as the inclusion of these issues may increase the fees that consultants seek to charge. If these issues are not included in the service agreement, there can be limited incentive for the consultant to raise them later. Similarly, in "retainer" or "pay-as-you-go" fee contracts, asset owners have limited incentive to raise ESG issues, as this may reduce the level of advice and support that can be provided on other issues.

This is a legitimate business issue. The development of ESG capabilities, research products, and the provision of ESG-related advice, can involve additional costs. While larger clients have often received high quality advice and support from investment consultants, it is often seen as a bespoke service offering, not necessarily as something that can be replicated for more resource-constrained asset owners. One of the points that has emerged from our research is that **there has been limited discussion of what a core (or universal) ESG service might look like**. One area of progress has been the rating of investment funds. Some investment consultants are now providing some information on the ESG performance of these funds, either alongside more conventional investment ratings or integrated into the overall fund rating. However, the reality is that questions relating to ESG issues tend to be optional on due diligence questionnaires, and no consultants exclude asset managers based on their responses to these ESG questions.

### FUND RATINGS

There are mixed approaches on how investment consultants provide ratings of funds managed by asset managers: a separate ESG rating alongside an alpha rating, or one integrated rating. The fund ratings of one firm we interviewed are comprehensive, with two ratings; an 'ESG integration' rating and a 'stewardship' rating.

However, in most cases ESG issues tend to be optional on due diligence questionnaires. Asset managers are "increasingly responding" to these questions, according to one interviewee. Most consultants understand ESG issues as separate from impact or screened investing. However, there are still consultants that consider ESG as ethical or non-financial. No consultants exclude asset managers based on responses to ESG-type questions. Few consultants ask about ESG stewardship.

Evidence shows that asset managers are becoming better at marketing their ESG capability. There is also some evidence that consultants are "getting better" at testing a fund's approach to ESG issues. However, in terms of the broad approach taken to ESG advice, the overwhelming conclusion is that ESG issues are seen as a stock-specific issue picked up by investment managers. The perception is that ESG issues only affect manager research and reporting for the consultant.

> "If the clients make ESG an integral part of the RFP process then we would factor that in the fee, because we know that it would include additional demands on our research team."

### EXPERTISE AND KNOWLEDGE GAPS

Investment consultants are a recognised source of investment expertise and to those clients that have been willing to pay for high quality advice on ESG issues, it has been delivered. However many interviewees commented that there are significant gaps in expertise and knowledge. In particular:

- Investment consultants are struggling to carry out consistent quantitative research on investment manager performance on ESG issues. This lack of research reinforces perceptions about the lack of materiality of ESG issues to investment performance
- Investment consultants have limited experience of assessing or monitoring investment managers' capabilities on ESG issues beyond listed equities
- Investment consultants tend to see ESG and responsible investment as primarily about whether and how these issues are taken into account at the level of the individual issuer (i.e. they are seen as being about stock-picking). Little attention has been paid to the relevance of these issues to asset allocation
- Asset allocation decisions tend to rely on backward-looking data which may not capture the impacts of new and emerging risks such as climate change. In addition, asset allocation models tend not to explicitly analyse individual sectors, which is where it is most feasible to assess and model the implications of ESG issues.

## POLICY AND REGULATION

Globally, we've seen growth in ESG-related regulation for asset owners and investment managers, but not investment consultants. We find that, where it exists, ESG regulation often has unclear objectives and weak drafting. It positions ESG as voluntary or in other words, not financially material, and not aligned with wider policy frameworks. We also found very little monitoring by regulators of ESG regulation[11].

11 https://www.unpri.org/download_report/22438

Our research has identified three important policy and regulatory issues that influence the relationships between asset owners and their investment consultants:

- the specific regulation that applies to investment consultants;
- the wider regulatory framework within which asset owners and investment consultants operate;
- the volume and rate of regulatory change.

The specific requirements for asset owners to use investment consultants differ between countries. Most countries do not impose any formal ESG requirements on asset owners, and no countries impose formal ESG requirements on investment consultants. Here we focus on the UK and US.

## UK

In the UK, the pensions act requires pension scheme trustees to "obtain and consider proper advice" on whether the investment is "satisfactory". The act defines proper advice as "the advice of a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investments of trust schemes"[12].

Most trustees fulfil this requirement by appointing an investment consultant, **however the content of the advice is currently not regulated**. While the regulation is clear that the decisions of UK pension fund trustees must be "personal and conscious acts" and not taken "under the dictation of another", our research finds that advice is often interpreted as instruction.

The FCA's Asset Management Market Study (final report issued in 2017) raised concerns about the investment consultant industry[13]. The study found that investors were struggling to assess whether they were receiving value for money from their consultants. It recommended that investment consultants be brought into the regulatory perimeter, subject to the outcome of a provisional market investigation by the Competition Markets Authority. The FCA's study did not fully address ESG factors.

There remains some ambiguity regarding the extent to which pension schemes must incorporate ESG issues in their investment processes and decision-making[14]. In its study of the fiduciary duties of investment intermediaries, the UK law commission concluded that "Where trustees think ethical or environmental, social or governance (ESG) issues are financially material they should take them into account"[15].

In March 2017, The Pensions Regulator clarified that trustees "need to take environmental, social and governance (ESG) factors into account if you believe they're financially significant"[16]. In September, 12 investment consultants, convened by UKSIF and AMNT, publicly committed to "draw the guidance to the attention of UK pension scheme clients"[17].

As of June 2018, The Department for Work and Pensions (DWP) is consulting on new regulatory proposals that would amend the required content of the Statement of Investment Principles (SIP). It would further require all trustees of all schemes which are obliged to produce a SIP to state their policy in relation to financially material considerations including, but not limited to, those resulting from environmental, social and governance considerations, including climate change.

## US

In the US, most investment consultants are regulated by the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940[18]. If a consultant does not meet registration requirements (based on assets under advice), they can register at State level. Similarly to the UK, the SEC disclosure requirements for consultants do not regulate the content of advice. However it does impose a "fiduciary duty" on consultants to provide "disinterested advice".

The Department of Labor (DOL) is the primary regulator for corporate retirement plans, benefits and savings. Public plans tend to be regulated at State level. In 2015, the DOL issued new guidance regarding "economically targeted investments" (ETIs) made by retirement plans. The guidance acknowledges that "environmental, social, and governance factors may have a direct relationship to the economic and financial value of an investment.

12 http://www.legislation.gov.uk/ukpga/1995/26/section/36/enacted
13 https://www.fca.org.uk/publications/market-studies/asset-management-market-study
14 https://www.unpri.org/download_report/24187
15 https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/
16 http://www.thepensionsregulator.gov.uk/guidance/db-investment.aspx
17 http://uksif.org/2017/09/25/investment-consultants-join-with-amnt-uksif-to-increase-client-esg-awareness/
18 https://www.sec.gov/about/laws/iaa40.pdf

When they do, these factors are more than just tiebreakers, they are proper components of the fiduciary's analysis of the economic and financial merits of competing investment choices"[19].

Our interviews found that consultants interpreted the guidance as clarification that pension plans *can* consider ESG factors, but not that they *must* consider ESG factors. While this guidance may have removed a barrier to ESG incorporation, it is not enabling it. A further announcement from DOL in April may have added some confusion as it advises that fiduciaries of ERISA covered plans must avoid too readily treating ESG issues as being economically relevant to any particular investment choice.

In the UK, US and globally, we've seen growth in ESG-related regulation for asset owners and investment managers, but not investment consultants. We find that, where it exists, ESG regulation often has unclear objectives and weak drafting. It positions ESG as voluntary or in other words, not financially material, and not aligned with wider policy frameworks. We also found very little monitoring by regulators of ESG regulation[20].

## CANADA

In Canada, there is little direct regulation or professional standards for investment consultants and there is virtually no direct regulation or professional standards related to ESG factors in investment advice and decisions. The strongest legal requirement is the requirement for pension plans registered in Ontario:

*'Under section 78(3), a plan's statement of investment policies and procedures (SIPP) is required to include information as to whether environmental, social, and governance (ESG) factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated.'*

Some investment consulting firms require investment consultants serving Canadian clients to be included in their SEC registration under the Investment Advisors Act of 1940. There are no specific ESG requirements from the SEC.

Securities Commissions regulate investing activity, but provide an exemption for sophisticated investors. Investors, such as pension funds, who invest over a minimum amount (e.g. $1 million in Ontario) are exempt and the Commissions focus their attention on protection of smaller investors.

> "The transition to ESG incorporation is limited by fiduciary fear. The DOL 2015 bulletin did help. However, there is the perception that the current administration will repeal that. Clients and advisers are worried about making a statement on ESG issues that they will need to retract."

The CIA Committee on Investment Practice, obtained a legal opinion regarding registration requirements which advised that OSC registration was not required by actuaries working as investment consultants. However, some investment consultants have voluntarily registered their firms under OSC particularly if they are providing advice on buying or selling individual securities.

Fiduciary duty is coded in Provincial pension legislation under the various pension benefits acts (PBAs). The requirements of the Ontario PBA are as follows:

*'The administrator has a duty of care and owes fiduciary duties to plan beneficiaries. The administrator must ensure that the pension plan and pension fund are administered in accordance with the Pension Benefits Act (PBA) and regulations, and the terms of the pension plan. The administrator is ultimately accountable to all participants of the pension plan (e.g., plan beneficiaries, plan sponsors and regulatory authorities).'*

The administrator (of an Ontario registered plan) may delegate some responsibilities however, '*these service providers – regardless if they are employees of the administrator or third parties – are subject to the same duty of care as the administrator.*' Even if tasks are delegated, the administrator is still ultimately responsible for ensuring that the pension plan and pension fund are being administered, and that the assets of the pension fund are being invested in compliance with the PBA, regulations and pension plan.

19 https://www.unpri.org/policy-and-regulation/global-guide-to-responsible-investment-regulation/207.article
20 See https://www.unpri.org/download_report/41204

The fiduciary duty requirements of other jurisdictions are similar, as they follow Common Law. The Province of Quebec is different as they apply civil law. In partnership with SHARE, the PRI prepared guidance for the Alberta Treasury Board and Finance (ATBF) in updating regulation and guidance on ESG disclosures.[21]

## AUSTRALIA

Investment Consultants in Australia are generally required to obtain an Australian Financial Services (AFS) licence to provide financial product and investment advice to asset owners and must comply with the AFS licence obligations. The general licence conditions include obligations to provide services efficiently, honestly and fairly, manage any conflicts of interest and ensure adequate financial, human and technological resources.

Trustees of superannuation funds are required to manage the fund in the best interests of beneficiaries, both under general trust law and under section 52 of the Superannuation Industry (Supervision) Act 1993. Superannuation fund trustees are also required to comply with the principles defined in Prudential Standards, which Australian Prudential Regulation Authority (APRA) is authorised to make. The Investment Governance section includes binding obligations on superannuation trustees to develop and implement an effective due diligence process for the selection of investments as part of an investment governance framework.

ESG factors are specifically contemplated in the related (however non-binding) prudential guidance SPG 530, which clarifies that there is no constraint to ESG factors being considered in making investment decisions so long as it is consistent with the other statutory supervision obligations and fiduciary duty.

The guidance also outlines that APRA expects a registered superannuation entity licensee would be able to demonstrate appropriate analysis to support the formulation of an investment strategy that incorporates ESG factors. So, where ESG factors are being considered, it is expected that investment consultants must include analysis to support this aspect of the investment strategy.

## PROFESSIONAL REGULATORY FRAMEWORKS

Professional bodies (CFA and actuarial bodies) are key standard setters in the investment consulting industry. They provide an assurance of quality to users of their members' services and provide codes regulating their professional behaviour and conduct. We found that self-regulatory requirements are also weak within these bodies; for example, **the professional qualification and accreditation obligations of actuaries do not include any formal requirements on ESG issues**.

The Institute and Faculty of Actuaries (IFoA) recently issued a Risk Alert to all its members on climate-related risks[22]. The Risk Alert is non-mandatory guidance recommending all actuaries considers how climate-related risk affect the advice they are providing.

## THE WIDER REGULATORY FRAMEWORK

A recurring theme in the PRI's wider work on the regulation of the financial system has been that **regulation fails to pay adequate attention to the responsibilities of investment actors for ESG issues**.

Clarifying these responsibilities is a key focus for the PRI's public policy engagement. In relation to fiduciary duty, for example, the PRI has pressed policy makers to clarify that asset owners must analyse and take account of ESG issues:

- In their investment processes
- In their active ownership activities
- In their public policy engagement
- Clarify that fiduciary duty requires that investors pay attention to long-term investment value drivers, including ESG issues.

The lack of formal obligations on asset owners to pay attention to ESG issues is one of the key reasons why asset owners have not systematically demanded that their investment consultants pay more attention to ESG issues.

21 https://www.actuaries.org.uk/documents/risk-alert-climate-related-risks

22 https://www.unpri.org/download_report/22177

A further issue is that companies and investors continue to neglect ESG considerations in their decision-making. The importance of ESG issues to their long-term success is systematically underestimated. This is a result of:

- Weaknesses in current regulatory and policy frameworks
- The lack of incentive provided by markets and market mechanisms (e.g. externalities)
- A lack of information and disclosure (e.g. information asymmetries).

## REGULATORY OVERLOAD

We are acutely aware that asset owners, in many countries, face increased regulatory burdens. This has had two effects.

Firstly, it has meant that policy makers have been reluctant to introduce additional regulatory requirements focusing on ESG issues. This reluctance is compounded by policy makers' lack of understanding of responsible investment.

Secondly, it has limited the time they have available to focus on ESG issues in their investment practices and processes.

"The level of regulation impacting on DB pension schemes has been extraordinary. Even the big pension schemes are struggling. There is a level of bandwidth with any scheme."

# POTENTIAL SOLUTIONS

Our central conclusion is that investment consultants are unlikely to take action on ESG issues without stronger incentives to do so from their asset owner clients.

Our research points to a series of interventions that could be made to fully integrate ESG issues as a standard part of investment consultants' service delivery. These are described below and are divided into three sections relating to market structure, investment practice, and policy and regulation.

## MARKET STRUCTURE

1. **Enable small to medium and resource constrained asset owners to pool and clearly express their ESG service demands**

The PRI could enable asset owners to work together to send consistent and aligned requests to investment consultants on their expectations of the ESG-related advice they expect to receive.

This could include sharing good practice ESG requirements in contracts and transparency on ESG costs and fees.

2. **Support policy interventions to increase pension scheme pooling**

The PRI could support policy interventions which increase the pooling of institutions. Larger institutional investors are more likely to build an internal resource and be an alternative source of innovation in ESG investment. A market of larger institutions would be more demanding of consultants and force them to adopt these ideas more quickly.

3. **Explore the development of a kitemark**

The PRI could explore the development of a kitemark or quality standard for the consultant market with professional bodies or regulators.

Such a kitemark or quality standard would certify that the consultant provides high quality advice on ESG-related issues. An alternative could be an industry benchmark for investment consultants on ESG service delivery.

## INVESTMENT PRACTICE

4. **Incorporate ESG in asset owner investment strategies and investment consultant beliefs**

The PRI supports asset owners to adopt investment strategies and embed ESG consideration as fundamental investment insight[23]. The PRI could support asset owners in asking their consultants to publish their ESG investment beliefs. This would include explanations of how these commitments align with fiduciary duties and of how they manage conflicts of interest.

The PRI could also encourage consultants to report publicly on how these commitments are being implemented in the research and advice they provide to clients. This reporting should include discussion of how the firm is developing its competencies and capacities in responsible investment, and how it is taking account of these in its fee models.

The PRI could work with consultants to develop and promote examples of the positive impact that ESG integration can have on investment returns. This is key if perceptions about ESG materiality and the barriers presented by investment consultants' views on fiduciary duties are to be addressed.

5. **Reframe the objectives, philosophy and composition of service lines**

The PRI could set up projects to assist investment consultants develop more advanced ESG integrated services. For example:

- Develop a full ESG overlay. This could support clients in understanding the ESG risks and opportunities in their portfolio construction. This could involve extending ESG analysis beyond listed equity to other asset classes, including alternatives and liability matched products. A starting point could involve lengthening the time horizon used to assess investment performance and developing tools to quantify ESG issues.
- Asset-landscape visioning project. This could be a theoretical project looking to understand how a world without all the norms of investment applying would work – efficient markets, listed investments and universal ownership. Such a project could challenge assumptions that have been identified as holding back more advanced approaches to ESG integration.
- Explicitly challenge EMH/CAPM and bias towards past data (Efficient Market Hypothesis and Capital Asset Pricing Model). Outputs could include papers providing alternatives to the CAPM approach to portfolio construction. This could be best served by coupling the content with factor investing which is currently breaking into the market.

23 For example, the PRI's "A practical guide to ESG integration for equity investing".

**6. Enable asset owners to explicitly account for ESG capabilities when appointing and reappointing investment consultants**

The PRI could publish guidance for asset owners on how to identify, select, appoint and monitor investment consultants. This could include suggested questions for due diligence and selection processes, and suggestions on what good practice looks like and measures of performance. It could also include guidance on:

- How consultants might be incentivised to build ESG capacity (e.g. through including this as a factor in appointment/reappointment decisions)
- How asset owners might use the data and information reported under the PRI reporting and assessment framework.

The PRI could ensure that this guidance is widely distributed through its asset owner network and could actively encourage its uptake. This could form part of the PRI's wider efforts to encourage asset owners to make commitments to responsible investment and to ensure that these commitments are effectively implemented.

**7. Publish minimum requirements on ESG**

The PRI could develop proposals on what the key elements of a good basic ESG advisory service looks like, and press for this to be a standard part of all consultants' offering to their clients. The PRI could provide transparency for asset owners on costs and benefits of more advanced ESG service provision.

**8. Develop expertise on ESG issues**

The PRI could make available the PRI Academy trustee training course for a reduced cost on the condition that investment consulting firms commit that all field consultants complete the course.

The PRI could support efforts to change market views on ESG issues by making these issues an integral part of professional training in, for example, CFA or actuarial exams. It could also work with these bodies to ensure that ESG issues are an integral part of continuous professional development (CPD) requirements for chartered professionals in these areas.

The PRI could work to ensure that ESG issues are an integral part of the codes of professional ethics such as those adhered to by holders of the CFA and the members of the actuarial professional bodies.

### THE PRI REPORTING AND ASSESSMENT FRAMEWORK

The PRI Reporting and Assessment Framework is the largest global reporting project on responsible investment. It was developed with investors, for investors. Signatories are required to report on their responsible investment activities annually. This ensures:

- Accountability of the PRI and its signatories
- A standardised transparency tool for signatories' reporting
- That signatories receive feedback from which to learn and develop.

Investor signatories are assessed against a range of indicators within each module. Transparency reports are available for public download from the PRI website.

From 2018 all PRI service provider signatories, including investment consultants, will be required to report annually on some of the themes addressed in this paper, such as ESG incorporation in advice, ESG beliefs and how this fits into their perspective on fiduciary duty. The responses to the reporting framework will be available on the PRI Data Portal. This will make service provider reports more accessible to investor signatories, which could contribute to enhanced dialogue between asset owners and investment consultants as well as improved knowledge sharing among investment consultants.

**9. Integrate ESG in the client-consultant relationship**

The PRI could re-publish or rework its practical guides (e.g. on ESG integration in listed equity and fixed income) to help illustrate and explain what good ESG advice by consultants should look like. The PRI could establish consultant networks for the sharing of case studies and experiences on ESG issues in order to develop best practice.

**10. Develop guidance on fiduciary management**

The PRI could publish guidance for investment consultants on full ESG incorporation in fiduciary management. This would include applying recommendations made in PRI's asset class guides to the investment consultant's fiduciary management business.[24]

## POLICY AND REGULATION

11. **Clarify that asset owners and asset consultants must consider ESG issues in investment processes**

The PRI and UNEP FI's fiduciary duty programme has concluded that failing to consider ESG issues is a failure of fiduciary duty. The programme is engaging regional and national governments to update investment regulation to clarify that fiduciary duties require investment decision-makers to consider ESG factors in their investment processes, and in the processes of their agents.

This could be extended to investment consultants, such that, as part of their duty of care requirements, they advise asset owners on all financially material risks and opportunities, including ESG issues.

12. **Work with professional bodies to incorporate ESG within professional regulation**

The PRI could work with professional bodies (such as the CFA and actuarial bodies) to ensure that ESG issues are an integral part of the codes of professional and technical standards adhered to by their members.

13. **Support policy interventions to put sustainability at the core of financial regulation**

The PRI could support policy makers by use of measurable objectives to articulate the role capital markets should play in contributing to a sustainable financial system. This would include provision for investment consultant-related regulation. In addition, policy makers should:

- Strengthen policy design: Tentative drafting and easy opt-outs mean responsible investment policy is often easy to disregard.
- Improve monitoring and communicate the impact.
- Clarify how regulators' mandates contribute to sustainable economies.
- Introduce mandatory corporate reporting on ESG issues.
- Build capacity (people and skills) for monitoring responsible investment implementation.

# NEXT STEPS

The publication of this report (December 2017) marks the start of a consultation with asset owners, investment consultants and other investment intermediaries on the barriers to action and the potential solutions set out in this report.

The PRI will host a number of workshops in multiple countries to solicit feedback. We also encourage written feedback which can be sent to policy@unpri.org (any feedback will be treated as confidential).

Following the feedback we will identify, prioritise and sequence projects that we believe will help to achieve our vision of full integration of ESG issues as a standard part of investment consultants' service delivery.

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**About the IC Research Institute**

The IC Research Institute is an independent provider of market intelligence data services on institutional investment consultants, realized by a unique combination of in-depth market knowledge and innovative information technology. The institute's core online service is a vital cloud-based NAVIGATION SYSTEM FOR CONSULTANT RELATIONS™ with truly global reach, in order to save time, money and "nerves" by shortening the sales management process and accelerating institutional business development. The institute's client base are institutions managing more than USD 8 trillion in assets, representing a 10% market share of the world's largest 500 managers. Its client loyalty and retention rate is 100%.

www.ic-research.org

### The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

## The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

### United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

### United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact