Level Up

An introduction to standards for responsible investment

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Executive summary

Standards for responsible investment are becoming increasingly important as more asset managers seek to promote their capabilities in the field. Investors, intermediaries, regulators and other stakeholders must have access to appropriate tools and consistent disclosure to judge the quality and effectiveness of asset managers' responsible investment programs.

This paper introduces readers to the current state of standards development in responsible investing.

We have identified several standards we believe are the most relevant and useful, including those from the Organization for Economic Cooperation and Development, Financial Stability Board, Principles for Responsible Investment, and United Nations. We support the arrival of investment fund rating methodologies such as those introduced by Morningstar and MSCI, but we recommend a cautious approach given some notable shortcomings.

We close our discussion by casting our eye to the future, where we see the continued proliferation of standards occurring simultaneously with a healthy degree of harmonization, adding up to the kind of rigorous, transparent disclosure that's sure to benefit all stakeholders.

More than words

As the world's financial commitment to responsible investment grows, so too does the scrutiny on asset managers' ability to meet that commitment with actions rather than words. Put differently, talk is cheap. And with more asset managers rolling out the responsible investment rhetoric every day, it's only getting cheaper.

Actions, on the other hand, are finally taking their rightful position as the means by which asset managers are held accountable to their claims. Activities that make up an effective responsible investment program – research, evaluation, engagement, analysis, education and more – must be demonstrably integrated with investment philosophy, strategy and process.

Further, the outcome of such activities must be measured and reported in the public sphere, with both quantitative and qualitative judgment as to progress and impact. Only then will current and prospective clients of investment management firms, as well as intermediaries, regulators and other stakeholders, have the information they need to conduct proper due diligence.

To accomplish this requires standard-setting across many facets of responsible investing. It has been, and will continue to be, a fitful process – and not without risk. We must guard against counterproductive efforts that serve only to entrench inefficient processes or outcomes. We must be mindful of an over-reliance on broad, quantitative metrics at the expense of depth. And of course, we must recognize the ever-present risk of unintended consequences. Taken together, the risks are certainly manageable, and are in fact to be expected; such is the price of progress.

Setting the terms

Standards are used to enforce and optimize a range of characteristics that apply to a product or process. Characteristics include such things as quality, transparency, repeatability, compatibility, speed to market, safety and interoperability. Typically, standards are developed over time by a group of participants with an interest in achieving the best outcomes *reliably* and *consistently*, for mutual benefit.

Standard-setting for responsible investment often follows a familiar path. Investment managers with well-established programs will voluntarily commit to upholding different sets of terms, often described as "frameworks," "guidelines" and "principles," set by organizations made up of global participants. The initial drafting of terms is typically a group effort, with founding supporters participating in open discussions about what should be included. Once an investment manager (or any type of institution or organization) becomes signatory to a set of terms, adherence is mandatory for continued recognition as a member firm.

Standards are not meant to act as a ceiling. The process is iterative, allowing room for leaders to push programs beyond the temporary confines of the current state through innovation and exploration, and then with consensus, advancing to the next level.

For the sake of simplicity, and to promote the evolution of quality standards in our field, we will refer to the various sets of terms as "standards," indicating any material distinctions or nuances as required.

A closer look

In the following pages we offer an introduction to four major standards, plus a fifth section that defines a category of related standards. We explain what they are and why they're important. We also share NEI's history with each standard, how we're reporting, and how we're contributing to further enhancements.

It's our belief, and increasingly, it's the belief of other asset managers and financial firms around the world, that adherence to these standards is prerequisite for a credible and authentic responsible investment program.

PRI Reporting Framework

Set by: Principles for Responsible Investment (the PRI)
Date established: The PRI was established in 2006; mandatory reporting introduced in 2014
Participation: 2,250+ signatories worldwide (US$80T in AUM)

To join the PRI, signatories must commit to upholding six principles, one of which is to "report on activities and progress towards implementing the principles."

Reporting is done annually through the PRI Reporting Framework, which takes the form of an online questionnaire. Submissions from all signatories are published as "transparency reports." Note that some data are required to be reported, but not necessarily made public.

To give an idea of scope, NEI's transparency report for 2017 is 77 pages long, with information such as how environmental, social and governance (ESG) practices are integrated into our policies and programs; how many companies we've engaged and the depth of those engagements; and, whether engagements have been collaborative and what role we've played, among many other topics.

The PRI reviews the submissions and assigns a letter grade to each report "module," covering areas such as engagement, strategy and governance. These letter grades form the final PRI Assessment. Assessments are not made public; however, they can be obtained by request through the PRI.

Why it's important

- Original and only standardized global reporting tool of its kind for investment managers
- High degree of transparency + public access encourages thorough, accurate reporting
- Supported by the United Nations
- Potential to serve as "master" framework for other standards, e.g., harmonization with Task Force on Climate-Related Financial Disclosures (see below)
- Enables signatories to gauge progress relative to peers, help strengthen internal processes and collaborate for improvement

Shortcomings

The PRI Reporting Framework is still evolving, along with industry characterization of what constitutes "best practice." This can cause the indicators and reporting criteria to shift from year to year, making it difficult to maintain consistency in performance measurement, especially given the self-reporting nature. Perhaps an unintended consequence of being among the first standards in the field, the PRI Reporting Framework tends to incent quantity over quality, with little consideration for the *depth* of responders' activities.

Our role

NEI was publicly reporting similar ESG program results well before the PRI was formed in 2006, as we’ve long considered it our duty to disclose to our investors and stakeholders the actions we take to improve outcomes.

In our 2019 assessment (for the 2018 year), NEI achieved a score of A+ in both "Strategy & Governance" and "Listed Equity — Active Ownwership" modules. "Active Ownership" refers to our corporate engagement program, including proxy voting. We achieved straight A's in the four remaining modules.

We continue to participate in consultations and other discussion forums to help evolve the PRI Reporting Framework. For example, we’re stressing the need to give adequate notice of proposed changes to indicators, which would allow asset managers to set up data collection systems in advance of the reporting year. We’re also calling for the PRI to avoid indicators that encourage large amounts of low-quality engagement.

Sustainable Development Goals

Set by: United Nations
Date established: 2016
Participation: All 193 UN member states

The SDGs serve as a global framework for achieving "sustainable development" by 2030. They seek to correct and manage today's unequal development paths among developed and developing countries, while ensuring that progress respects human rights and is carried out through environmentally sound practices.

There are 17 SDGs and 169 related targets for monitoring progress. Goals touch on themes such as reducing poverty, reducing inequality, responsible consumption and production, climate action and gender equality.

While there are no formal standards or reporting requirements at the time of this writing, expectations are rising that investment managers will be held formally accountable. In April 2019, the UN established a group called the Global Investors for Sustainable Development, tasking them with creating a framework to define standards for investments aligned with the SDGs. The UN Global Compact, a "voluntary initiative based on CEO commitments to implement universal sustainability principles and to take steps to support UN goals," has published guidance on how companies can report the impact they're having on the SDGs and targets.

Put simply, investment managers with a claim to sound responsible investment practices who cannot prove alignment or measure impact against the SDGs risk being left behind.

Why it's important

- SDGs have been embraced by the investment community; healthy peer pressure applied on a global scale
- "Strength in numbers:" the more capital allocated to mandates and activities aligned with SDGs, the more likely targets will be reached
- Especially relevant for impact investing mandates; tailoring mandates to SDGs should optimize impact

Shortcomings

With limited guidance to date, there's a risk that asset managers may go only as far as to map *existing* processes to the SDGs. The expectation requires deeper change, with firms analyzing their programs and eliminating negative impacts while elevating positive ones – and documenting it all.

Our role

Our ongoing work naturally relates to many SDGs; however, our initial engagement efforts for 2019 are focused on these five goals, allowing for flexibility:

- Good health and well-being
- Reduced inequalities
- Responsible consumption and production
- Climate action
- Peace, justice and strong institutions

We intend to track and publish our progress with the same rigour we apply to all reporting initiatives. Preliminary work includes adapting existing data capture methodologies to fit the SDGs.

OECD Guidelines for Multinational Enterprises

Set by: Organization for Economic Cooperation and Development
Date established: 1976, most recent updates in 2011
Participation: Backed by almost 50 countries

The OECD Guidelines for Multinational Enterprises provide "voluntary principles and standards" for responsible business conduct, "consistent with applicable laws and internationally recognised standards."

In 2017, the OECD published *Responsible business conduct for institutional investors: Key considerations for due diligence under the OECD Guidelines for Multinational Enterprises.* This document clarified that the OECD Guidelines also apply to investors *in relation* to their holdings. In other words, investment managers can – and will – be held accountable for the behaviour of companies within their portfolios.

The OECD says the purpose of its due diligence guidance is to "prevent or address adverse impacts related to human and labour rights, the environment, and corruption in [institutional investors'] investment portfolios." The guidance lays out investors' responsibility to do no harm; they should prevent and mitigate severe adverse impacts by the companies in their portfolio. Importantly, that holds true even if the investor is not a majority shareholder. No matter the size of the stake, asset managers are accountable.

Asset managers are responsible to "know and show." They should have a system in place to capture potential risks ("know"), and they should be able to demonstrate actions taken to address any issues ("show"). The preferred action is corporate engagement, with divestment a last resort.

Why it's important

- OECD Guidelines apply to companies regardless of whether they've declared their adherence; in other words, this standard chooses you
- Asset managers can be held accountable for the behaviour of companies in their portfolios regardless of the size of their investments, even if they've never heard of the guidelines

Shortcomings

While the guidance outlines basic responsibilities and expectations, it does not provide a consistent framework for identifying and monitoring risks. This opens the door to variations in interpretation that could have potentially serious consequences for investment managers. In addition, there is no central, accessible repository to track cases of companies found to be in violation of the guidelines.

Our role

NEI consulted on the guidance, helping shape current expectations. We've developed and implemented a "know and show" process to identify and mitigate adverse impacts from companies in our funds in line with the guidance. We're also contributing to specific guidance for banks, with a direct tie to our ongoing engagement work on responsible lending.

NEI was a founding member of the Investor Alliance for Human Rights, which is working to promote wider adoption of appropriate due diligence regarding human rights issues among a broader institutional investor base, in line with the expectations of the OECD.

Task Force on Climate-Related Financial Disclosures

Set by: Financial Stability Board
Effective date: 2017
Participation: 580+ supporters; 32 Canadian (majority are investment managers)

The Task Force on Climate-Related Financial Disclosures was established by the Financial Stability Board in late 2015. Its mission is to "develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurers, and other stakeholders," recognizing climate change as a systemic risk to the financial system.

The Task Force is oriented toward investors and financial markets in a unique and important way, with disclosure guidance applicable to all players, including banks, insurers and investors: "The work and recommendations of the Task Force will help companies understand what financial markets want from disclosure in order to measure and respond to climate change risks, and encourage firms to align their disclosures with investors' needs."

Supporters are required to report against four defined "pillars:" governance, strategy, risk management, and metrics and targets. The Task Force recommends firms include their climate-related financial disclosures in their annual financial statements.

Why it's important

- The TCFD has quickly become the de facto standard on climate-related disclosures
- One of very few standards applicable to both corporations and investment managers
- Integrated into most major corporate reporting standards, including the PRI, Sustainability Accounting Standards Board, Global Reporting Initiative, and CDP (formerly Carbon Disclosure Project)

Shortcomings

The initial ask of investment managers includes disclosure of their carbon footprint. The size of a carbon footprint is determined by approximating the amount of carbon emissions a portfolio "owns" through its investment in assets that have real-world greenhouse gas emissions. It's a new tool that's hindered by a lack of quality data and the backward-looking nature of carbon metrics. Historical greenhouse gas emissions do nothing to tell us what the strategy is for mitigating risks associated with the transition to a low-carbon economy. We do anticipate it will be more useful in the future as data and methodology improve.

There is a marked lack of guidance related to social responsibility. Firms are not called to account for the social impact of their carbon reduction efforts, which are known to have lopsided effects on regions and communities in the absence of holistic change management oversight.

Our role

NEI participated in the original consultation on the TCFD, and as a supporter, we're committed to working with companies in our funds to drive adoption of the framework and to report against it. Along with other investment managers, we're pushing for the TCFD framework to be integrated with securities regulations in Canada and elsewhere.

To help solve the challenge identified above, we're engaging companies with the aim of improving data collection and reporting to foster better alignment with the TCFD. As a practical example, we have opened a dialogue with every company in one of our Canadian equity funds as part of a pilot engagement project – that's 33 firms as of March 2019.

NEI is also participating in nine Climate Action 100+ dialogues and co-leading two of them, where a primary objective is to create/improve alignment with the TCFD. Climate Action 100+ is an investor initiative that brings together more than 320 asset managers with over US$33 trillion in AUM. The goal is to ensure the world's largest corporate greenhouse gas emitters are acting to curb the effects of climate change.

Investment fund sustainability ratings

Set by: Morningstar, MSCI, Fundata
Effective date: Various

Investment fund ratings represent a more traditional and long-standing form of standardization that's focused on individual funds. Performance ratings are typically generated through a purely quantitative methodology, incorporating investment returns and risk metrics to identify how a fund stacks up relative to its peers.

In recent years, globally recognized ratings providers such as Morningstar have begun to offer sustainability ratings as well, giving mainstream investors and their advisors a simple, straightforward way to compare solutions in the context of responsible investment.

Ratings providers use proprietary assessment methodologies, which score individual fund holdings based on ESG performance. Ratings for each fund's holdings are amalgamated to produce an overall fund sustainability rating. Some systems base their fund ratings on ESG performance (of the underlying holdings) broadly, while others might focus on a single metric, such as low-carbon ratings.

Why it's important

- Signals a welcome level of interest in responsible investing; underscores message that sustainability is a meaningful due diligence consideration when selecting investments
- Helps drive awareness and access to information for mainstream investors

Shortcomings

As helpful as they may be in providing a topline sustainability snapshot, ratings such as these must be approached with caution.

- Different underlying methodologies among providers could lead to potentially significant discrepancies among ratings for the same fund
- Ratings tend to be heavily influenced by factors such as company size, efforts spent on disclosure, and local regulations; funds following certain themes related to size or region may be disadvantaged
- No accounting for intentionality; for example, there is no way to distinguish between a fund that invests only in companies providing clean technology solutions and one that focuses only on the ESG scores of companies

Our role

NEI consulted with Morningstar during creation of the rating system to express concern over what we perceived to be significant shortcomings (described above). We continue to look for opportunities to work alongside Morningstar to evolve the system.

Finding the way forward

As with any growing industry or field of study, standards evolve over many years. Once the ball gets rolling, there typically follows a period of proliferation as disparate, regionally-focused organizations set their own standards to suit specific groups of stakeholders. As time goes on, these various standards begin to coalesce under larger, global entities. The initial goal is harmonization among standards to eliminate contradiction and limit overlap.

Finally, as participation increases and the feedback loop among standards and stakeholders strengthens, the more comprehensive and widely-recognized standards absorb the less significant and redundant ones and the landscape shrinks, creating greater clarity, efficiency and overall ease of use.

It's our view that standards for responsible investment are in the early stages of proliferation, with pockets of harmonization helping keep stakeholders moving in the same direction with a reasonable degree of clarity.

In March 2019 for example, the International Finance Corporation, a division of The World Bank, published the highly anticipated *Investing for Impact: Operating Principles for Impact Management.* The stated purpose is to "describe essential features of managing investments into companies or organizations with the intent to contribute to measurable positive social or environmental impact, alongside financial returns." But again, we're in a grey area – this is technically a set of principles, not a standard as such. The IFC allows that "a variety of tools, approaches, and measurement frameworks may be used to implement the Principles."

Another important development is the likely arrival of the ISO. In 2018, members voted to create a new Technical Committee on Sustainable Development, with the following scope: "Standardization in the field of sustainable finance for the integration of sustainability considerations and environmental, social and governance (ESG) practices into institutional investment decision making and wider finance management. It will ultimately look to support the alignment of the global financial system with the sustainable development goals."

We expect to see more standards over the next few years – some much needed, others simply variations on a theme – even as the ones in place today become more thorough, polished, and entrenched.

It must be acknowledged that not every aspect of responsible investing can be numerically quantified for the purpose of a standard. We must work to establish a means of measuring the "success" of responsible investment programs and funds in a different context than traditional quantifiers – namely – financial returns and the risk that we take to achieve them. Put another way, there is more to life than money.

For our part, we continue to work with industry peers and other stakeholders to report against existing standards, refine what's working, eliminate what's not, and help drive the positive evolution of standards for responsible investment.

Key takeaways

- Asset management firms now have access to globally recognized guidance, plus measurement and reporting tools to benchmark progress

- Adherence to the following standards and affiliation with related standard-setting bodies should be considered prerequisite when assessing responsible investment programs:

    - **PRI Assessment**
    - **OECD Guidelines for Multinational Enterprises (and related due diligence guidance)**
    - **Sustainable Development Goals**
    - **Task Force on Climate-Related Financial Disclosures**

- ESG performance ratings such as those provided by Morningstar and MSCI are a welcome addition to the responsible investment landscape, but should be used with caution

- Expect standards for responsible investment to grow more rigorous in the years ahead, putting increasing pressure on asset managers to live up to their claims

NEI Investments has been a leader in responsible investment for more than 30 years. It's our mission to continue to drive the evolution of the field, improving outcomes for clients every step of the way.

Speak with your advisor today about how our responsible investment solutions can help you make a positive difference on the world.

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