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RESPONSIBLE INVESTMENT FOR PENSION FUND TRUSTEES: A WORK IN PROGRESS?

A high-level overview of the current status of the legal and industry-led framework for responsible investment by pension funds and their trustees in South Africa[1]

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Available at www.wwf.org. za/responsible_investment_pension_fund_trustees

The final version of the Code for Responsible Investing in South Africa (CRISA) was launched with considerable fanfare in the institutional-investment arena. Up until the launch there had been a fair amount of talk in the industry about the topic of Responsible Investing (RI), the UN PRI [Principles for Responsible Investment] and the initial drafts of CRISA – and a fair amount of talk afterwards. Now it is time for decisions and actions.

– Prasheen Singh, *Today's Trustee*[2]

1. INTRODUCTION AND SCOPE

Investment ownership and management is a dynamic process. The prudence of an investment depends on the circumstances of each particular case.

Environmental, social and governance (ESG) factors in investment decision-making and practice affect the value of an investment, and are essential considerations for responsible investment by trustees of boards representing pension funds.[3]

ESG management can have a profound impact on an investment in the short or long term. Understanding ESG factors means better understanding current investment value, gaining insight into future value, and finding opportunities to achieve superior risk-adjusted returns for beneficiaries, particularly over the long term.[4]

This briefing paper is aimed at boards of trustees representing pension funds ("trustees"). Its purpose is to assist trustees in understanding and implementing responsible investment[5] practices by providing guidance on the legal and industry-led environment for responsible investing in South Africa.

[1]The purpose of this briefing paper is to provide a high-level overview of the legal and voluntary framework for responsible investing by pension funds in South Africa for information and discussion purposes in the non-legal arena. It does not constitute legal advice. This information, while based on sources that the writer considers reliable, is not guaranteed to be accurate and may be incomplete. Legislation, policies, standards and guidelines considered in this briefing paper are, to the best of the writer's knowledge, valid as at 13 May 2013. The preparation of this paper included desktop reviews and research of the relevant legislative provisions, the common law and various articles published on responsible investing in South Africa, and limited informal interviews conducted with investors and other stakeholders in April 2013. Views and any errors in this briefing paper or in the interpretation of reports, papers or commentary on which the writer has relied, are the writer's own.
[2]"Get Ready for CRISA", December 2011/February 2013, editorial in *Today's Trustee*, www.totrust.co.za/28112011_responsible.htm, accessed 23 April 2013
[3]*Responsible Investment and Ownership: A Guide for Pension Funds in South Africa* (final review draft), International Finance Corporation and Sustainable Returns Project, March 2013
[4]*Responsible Investment Explanatory Memorandum, 2009, Government Employees Pension Fund* (GEPF)
[5]There is no unanimously accepted definition for responsible investment. This paper does not address such issues. For the purposes of this paper, sustainable and responsible investment are used interchangeably, and mean "an investment practice that intentionally integrates any factor that may materially affect the sustainable performance of an asset or portfolio of assets, including factors of an environmental, social and governance character." Given the high-level nature of this briefing paper, the writer has focused on the environmental component of ESG factors – namely carbon and water constraints.

In particular, it sets out to:

- **Examine if and how our legal and self-regulatory framework has developed since late 2011.**[6] Responsible investment practices are affected by a range of policies, laws and principles, but this paper specifically considers the relationship between fiduciary duties and the consideration of ESG issues at common law, the amendments to Regulation 28[7] under the Pensions Fund Act[8] where they refer to ESG considerations ("Regulation 28"), the Principles for Responsible Investment (PRI)[9] and CRISA[10].
- **Encourage debate and discussion around how trustees can develop responsible investment strategies and ownership practices "fit for practice" in a changing climate and water-constrained world.** This paper considers two case studies – one focused on the Government Employees Pension Fund (GEPF), a defined benefit pension fund, and the other on the Metal Industries Provident Fund, a defined contribution fund. It also considers the work being done by the Sustainable Returns for Pensions and Society Project (referred to as the "Sustainable Returns Project").
- **Summarise some practical recommendations and tips for trustees** in implementing responsible investment practices compiled during research for this paper.

This paper should be read together with:

- WWF's 2011 paper, A High-level Overview of the Legal and Self-regulation Framework for Sustainable Investment by Institutional Investors in South Africa,[11] which this paper serves to update and elaborate
- The WWF Navigating Muddy Waters report series,[12] which provides empirical research to investors that may guide them in implementing policy and investment strategies to support responsible investment in the context of carbon and water constraints.

This paper discusses legal obligations and provisions. Every effort has been made to ensure that the paper is accessible. However, not all legal jargon could be avoided.

> Achieving sustainable growth from an asset on a finite planet requires that investors consider ESG (Environmental, Social and Governance) aspects when making investment decisions.
>
> - Investment Solutions, Responsible Investing Questionnaire Feedback, October 2012[13]

2. AN OVERVIEW

The nitty gritty of implementing ESG criteria in investment decisions and ownership practices

Research by Investment Solutions "revealed a lack of clarity as well as some frustration amongst both local and global investment managers as to what the practical implications of implementing responsible investing are - and whether clients are ready to accept that a focus on sustainability requires a shift in focus from short to long term".[14]

[6]When the briefing paper headed *A High-level Overview of the Legal and Self-regulation Framework for Sustainable Investment by Institutional Investors in South Africa*, written by Aimée Girdwood and published by The World Wide Fund for Nature SA (WWF) and the British High Commission, was published.
[7]Promulgated in terms of section 36 of the Pension Fund Act (defined below). Government Notice (GN) R 98 of January 1962 (as amended). Regulation 28 was substituted by GNR.183 of 4 March 2011. Regulation 28 covers prudential investment guidelines and governs permitted levels of exposure to different asset classes.
[8]Pension Fund Act No. 24 of 1956, as amended (the Pension Fund Act)
[9]Launched in 2006 by then UN Secretary-General Kofi Annan. The process of developing the PRI was jointly managed by the United Nations Environment Programme (UNEP) Finance Initiative and the UN Global Compact.
[10]*The Code for Responsible Investing in South Africa*, July 2011, Institute of Directors in Southern Africa
[11]*A High-level Overview of the Legal and Self-regulation Framework for Sustainable Investment by Institutional Investors in South Africa*, August 2011, Aimée Girdwood, published by the WWF and the British High Commission, available at http://awsassets.wwf.org.za/downloads/ggsa_paper_girdwood_regulatory_context.pdf, accessed 30 May 2013
[12]A report series published by WWF in collaboration with Carbon Tracker, SinCo, Trucost, the GEPF and others. The series is made up of the following reports: Part 1: Carbon and water risks for South Africa's top companies, bonds and equity funds, Part 2: Unburnable carbon: Budgeting carbon in South Africa, Part 3: *Shuffling Feet – Institutional Investor Attitudes to Climate Change Portfolio Risks*, Part 4: *Responsible investing for climate change and water in South Africa* and Part 5: *Navigating Muddy Waters: Securing investment returns under carbon and water constraints*; late 2012; all (other than the Shuffling Feet paper) available at www.wwf.org.za/media_room/publications/index.cfm?uPage=1, accessed 30 May 2013.
[13]"Understanding sustainability from an asset management industry perspective", 12 October 2012, *ITINews*, www.itinews.co.za/companyview.aspx?cocategoryid=84&companyid=88&itemid=B383AAE3-24EB-47C7-80B7-34C489DE053F , accessed 14 May 2013

The meaning of responsible investment is varied, and the understanding of how it is best practised is dynamic and evolving.[15] So the legal and industry-led environment for responsible investing in South Africa is also still developing. But the good governance of pension funds and trustees' fiduciary duties[16] remain at the heart of trustees' roles, responsibilities and legal obligations. These require that trustees act in the best interests of the current and future members of the pension fund. Trustees need to proactively incorporate and enable ESG criteria in investment decisions and ownership practices.

This is where the challenge lies for trustees. Our courts' understanding and interpretation of ESG considerations in the context of fiduciary duties is undeveloped. In addition, while Regulation 28 requires the consideration of ESG issues in assessing factors that materially affect the sustainable long-term performance of a fund's assets, it offers broad principles rather than specifying the approach to be adopted by trustees in meeting this obligation.

So how do trustees set about practically interpreting and implementing ESG considerations in the face of their fiduciary duties and the principles of Regulation 28? Research for this paper indicates that there is little doubt that, to the extent trustees consider that ESG factors impact on the financial performance of an investment, they must take it into account. Complying with fiduciary duties requires more than referring to a consideration of ESG criteria in investment policy statements and investing in a diversified set of assets. It also requires[17] stewardship and accountability, increased and proactive engagement on ESG criteria, clarity on trustees' requirements in respect of ESG criteria in their mandates with service providers, and increasing understanding of the risks and opportunities that these factors present to portfolios over the long term. Trustees who pay attention to ESG factors will probably improve the governance of pension funds and more accurately value funds' assets, liabilities and long-term performance, and so better honour their mandate in investing responsibly on behalf of beneficiaries.

Accountability through the reaction of the market remains, in principle, one of the most effective ways of ensuring the implementation and effectiveness of Regulation 28. Voluntary frameworks for responsible investment like the PRI and CRISA seek to play this role and provide trustees with a good basis to understand and implement ESG criteria.

But research indicates that the majority of pension funds in South Africa have not been active in taking up and implementing the principles of PRI and CRISA. So the PRI and CRISA seek to target and assist pension funds in their ongoing work. In addition, the Sustainable Returns Project aims to provide trustees with practical assistance in implementing the responsible investment principles of Regulation 28 and CRISA by developing information, frameworks, training and tools to support trustees. This process is ongoing.

These principles and tools should be considered in conjunction with other applicable and available standards, codes of good practice, guidelines and toolkits regarding responsible investment. Trustees will need to assess the applicability of each recommendation and determine whether the costs involved in implementation are justifiable. Trustees need to decide on a strategy and processes for implementation applicable to their own circumstances and the beneficiaries that they service in accordance with their own fiduciary duties.

Many of these issues will be a matter of negotiation between the trustees and their asset managers, and a subject for ongoing assessment over the life of this relationship. This paper includes two case studies and some recommendations and tips for trustees which the writer hopes will assist them in starting or furthering the process of ESG consideration and implementation in their portfolios, and facilitate a broader discussion around the understanding, application and implementation of ESG criteria in South Africa.

[14]Ibid
[15]*Responsible Investment and Ownership: A Guide for Pension Funds in South Africa* (draft), 23 October 2012, International Finance Corporation and Sustainable Returns Project
[16]Circular PF 130: "Good Governance of Retirement Funds", 11 June 2007, Financial Services Board (FSB)

Policy signals, legislation and complementary, industry-led frameworks currently promote the role of pension funds in responsible investment on a principles-led basis in South Africa. The meaning of responsible investment and how it is best practised is "dynamic and evolving as a result of growing experience, continuing innovation and the need to respond to emerging issues".[18]

While it is a fundamental principle of our law that trustees as fiduciaries "must, at all times, act with the utmost good faith and in the best interests of the fund and its beneficiaries (present and future) and with the proper degree of prudence, skill, care and diligence",[19] an understanding of the relationship between fiduciary duties and ESG factors in investment decision-making and practice, and the legislative and industry-led environment in respect of responsible investment in South Africa, remains relatively new. In particular, given that Regulation 28 came into effect on 1 January 2012[20] and CRISA on 1 February 2012, the legislative and industry-led environments have arguably not been in operation long enough for their effect or their means of implementation to be properly assessed and understood.

Within this context, this paper sets out a high-level review of the relationship between fiduciary duties and ESG issues at common law, Regulation 28, the PRI and CRISA. This review should be read together with, and as an update to, *A High-level Overview of the Legal and Self-regulation Framework for Sustainable Investment by Institutional Investors in South Africa*[21] for the reader to have a better understanding of the legal and industry-led framework for responsible investing in South Africa.

> Regulation 28 makes it clear that [responsible investment] is not only consistent with fiduciary duty, but is in fact a core element of good governance for retirement funds in South Africa.
>
> - *Draft Responsible Investment and Ownership: A Guide for Pension Funds in South Africa*, the International Finance Corporation and the Sustainable Returns Project [22]

3. UPDATE ON THE REQUIREMENTS FOR RESPONSIBLE INVESTMENT AND THE STATUS OF THEIR IMPLEMENTATION

A. RULES OF THE GAME

While the scope of this aspect of the review is limited to a consideration of fiduciary duties at common law and Regulation 28,[23] the development and interpretation of these take place within the context of a number of international and national policy[24] and legislative[25] initiatives and commitments that emphasise, among other things, the need to develop our economy sustainably. This includes developing while reducing the negative impact on the environment and achieving positive returns for society.

[17] Subject to the necessary limits on the discretion and decision-making abilities of fiduciaries.
[18] See note 15
[19] See note 11
[20] Notice No. 1 issued by the FSB, 10 June 2011
[21] See note 11
[22] See note 15
[23] Particularly, circulars issued by the Registrar of Pension Funds; the Conditions for Administration of Pension Funds, 2002 the Financial Advisory and Intermediary Services Act, 2002; and regulations and board notices promulgated thereunder; the Financial Institutions (Protection of Funds) Act, 2001; the Collective Investment Schemes Control Act, 2002 and the Securities Services Act, 2004 fall outside the scope of this paper.
[24] These include the National Development Plan 2030 (National Planning Commission, 2012), the National Climate Change Response Policy White Paper (Department of Environmental Affairs, 2011), the Green Economy Accord (Department of Economic Development, 2011), the National Growth Path Plan (Department of Economic Development, 2010), the Carbon Tax Discussion Paper (National Treasury, 2010), Pronouncements on a Carbon Emissions Tax in the National Budget Review 2012 (National Treasury, 2012), Pronouncements on a Carbon Emissions Tax in the National Budget Review 2013 (National Treasury, 2013) and the Carbon Tax Policy Paper: Reducing Greenhouse Gas Emissions and Facilitating the Transition to a Green Economy (2 May 2013).
[25] There are numerous pieces of national legislation that inform ESG considerations. In respect of environmental considerations alone, these include section 24 of the Constitution, the National Environmental Management Act, the National Water Act (No. 36 of 1998, as amended), the National Environmental Laws Amendment Act, the National Environmental Management: Air Quality Act, the National Environmental

“The relationship between fiduciary duties and ESG considerations in investment policymaking and practice as expressed in our case law is unclear at this stage but the consideration of ESG factors is arguably legally permissible.”

– Aimée Girdwood and WWF:[26] *A High-level Overview of the Legal and Self-regulation Framework for Sustainable Investment by Institutional Investors in South Africa.*

(I) Fiduciary Duties and ESG Issues – Where Do Things Stand?

Fiduciary duties are duties that are imposed upon a person who undertakes to exercise a discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence.[27] It is a fundamental principle of our law that trustees, as fiduciaries must at all times act with the utmost good faith and in the best interests of the pension fund and its beneficiaries (present and future) and with the proper degree of prudence, skill, care and diligence.[28]

“Our common law is an important source of fiduciary duties.”[29] The relationship between fiduciary duties and ESG considerations in investment policymaking and practice remains to be decided upon and clearly expressed in our common law.[30]

However, the case law indicates[31] that an investment’s compliance with a trustee’s fiduciary obligations will be decided on a case-by-case basis. Trustees have a fiduciary duty to act in the interests of beneficiaries, whose benefits depend on the responsible management of fund assets. In exercising this duty, trustees are required to take account of all relevant factors, and disregard irrelevant factors.

While there is uncertainty as to the extent to which non-financial considerations (such as ESG) are relevant for the purposes of investing pension fund assets, there is little doubt that to the extent that ESG factors may impact on the financial performance of an investment, they must be considered. Prevailing and anticipated future economic realities must therefore be taken into account when determining whether an investment decision is justified. Integrating ESG issues into investment analysis and decisions so as to more reliably predict the long-term performance of a particular business entity, and therefore the financial performance of the investment, is therefore arguably both allowed and demanded by the law. This consideration will require trustees to strike a careful balance in acting in the best interests of both present and future beneficiaries.[32]

Trustees also have a fiduciary duty to exercise their ownership rights and responsibilities so as to signal concerns and encourage change where they believe it necessary to protect the investment value over the long-term in entities in which their fund has an interest – thereby enhancing the fund’s ability to meet current and future liabilities.

The provisions of Regulation 28 and CRISA (set out in more detail below) that require the consideration of ESG factors as part of the fulfilment of duties by trustees and sound governance will likely also have a bearing on our court’s understanding and interpretation of ESG considerations in the context of trustee’s fiduciary duties.[33]

In practice, trustees employ the services of external asset managers, asset consultants and risk consultants to assist in the performance and carrying out of certain of their tasks.[34] Although a trustee’s duties may be delegated in this manner, trustees remain ultimately responsible for and liable to act with proper care and due diligence when managing fund assets. They should regulate their relationship with asset managers (including the consideration of ESG as part of responsible investing) contractually to ensure compliance with their fiduciary duties.

Management: Biodiversity Act, the National Environmental Management: Waste Act, the National Energy Act and the Electricity Regulation Act.
[26]See note 11
[27]*A legal framework for the integration of environmental, social and governance issues into institutional investment*, October 2005, UNEP Finance Initiative and Freshfields Bruckhaus Deringer
[28]This is an accepted principle of our case law reflecting in a number of cases including *Sackville West v Nourse and Another* 1925 AD 516; *Cowan & Others v Scargill & others* [1984] 2 All ER 750 (ChD); *Administrators, Estate Richards v Nichol and Another* 1999 (1) SA 551 (SCA) and *TEK Corporation Provident Fund & Others v Lorentz* 1999 (4) SA 884 (SCA). This principle is also set out in the Financial Institutions (Protection of Funds) Act 28 of 2001 (as amended), the Pension Fund Act and its Regulation 28, Circular PF No. 130: Good Governance of Retirement Funds, a guidance note issued by the FSB and referred to above (see footnote 16)
[29]See note 11
[30]Ibid
[31]*Administrators, Estate Richards v Nichol and Another* (see footnote 28). This is a Supreme Court of Appeal decision and so its findings will be binding on lower courts in South Africa. The relevant statement was not a finding of the court and will be considered persuasive, but not binding on our courts. Also see *Cowan & Others v Scargill & Others* (see footnote 28): this is an English law case, but its findings, and therefore the commentary in respect of this case, will likely be considered as persuasive in South African courts. This judgment has been used as a basis to argue that those responsible for managing trusts with a financial purpose are required by their fiduciary duties to put profit maximisation above all other considerations. However, respected legal commentary and opinion suggests that the judgment in the Cowan case has been misinterpreted in this sense. The Cowan case did not consider the question of taking ESG considerations into account in investment decisions and the impact this may have on investment returns. It has also been argued that the fiduciary duties will still be fulfilled by trustees who allow for the influence of other relevant considerations “provided they treat the purpose of the investment power (ordinarily the creation of financial benefit) as the primary purpose…” (*A High-level Overview of the Legal and Self-regulation Framework*)
[32]See note 11
[33]Ibid

(II) The Pension Fund Act and its Regulation 28

An effective and responsible ESG investment environment demands both good policy and the implementation of that policy. Given that our common law has not clearly expressed the relationship between fiduciary duties and ESG considerations, policy and regulations that recognise that ESG factors must be considered in discharging fiduciary and statutory duties, such as Regulation 28, are key.

(a) Recap of Regulation 28 in principle and its application
The responsibility of pension funds and trustees towards "sound retirement investment"[35] is at the heart of the purpose of Regulation 28.[36]

Sound retirement investment requires, particularly, that a fund ensures that its assets (of all categories and classes)[37] are appropriate for its liabilities[38] and that it understands the changing risk profile of its assets over time.[39] The meeting of trustees' fiduciary duties requires that "*appropriate* consideration" be given to "*any* factor which may *materially* affect the *sustainable long-term* performance of a fund's assets"[40] (emphasis in the original). Regulation 28 explicitly requires the consideration of ESG issues in this regard,[41] and requires that the pension fund's investment policy statement address this issue. This principle-based (as opposed to a rules-based) approach is intended to allow trustees to determine the approach that will enable them to meet their legal obligations in their particular circumstances.[42]

The Pension Fund Act and its Regulation 28 applies to "any pension fund"[43] subject to, amongst other provisions, "any other law in terms of which a fund is established."[44] On an ordinary reading of this provision, this can be interpreted to mean that Regulation 28 will apply to pension funds in South Africa that have been established in accordance with their own unique pieces of legislation – unless such legislation specifically excludes or conflicts with the provisions of the Pension Fund Act and its Regulation 28. This will need to be considered on a case-by-case basis.

For example, a high-level review of the Act and rules applicable to the GEPF[45] indicates that the trustees of the GEPF are required to manage the fund by exercising the powers, performing the functions and carrying out the duties "conferred upon, assigned to or imposed upon" them in terms of the GEPF's Act and its rules.[46] This Act and its rules do not specifically provide for the consideration of ESG issues.

However, they do require that trustees act at all times with due care, diligence and in good faith, and that the operation and administration of the GEPF comply with its Act and all other applicable laws. Although the Pension Fund Act and its Regulation 28 may arguably not apply to the GEPF on this high-level interpretation, the consideration of ESG issues as part of the trustees' fiduciary duties (as referred to in section 3(A)(I) above) is arguably still required. Other pension funds in terms of which this review should also be conducted include the Transnet Pension Fund.[47]

The Financial Services Board may, on written application by a pension fund or in general, exempt a pension fund, or categories, types or kinds of pension funds, from all or any of the provisions of Regulation 28, subject to conditions that the Financial Services Board may impose.[48]

[34] This note is aimed at pension funds that typically employ external managers by way of mandate.
[35] *Explanatory Memorandum on the Final Regulation 28 that Gives Effect to Section 36(1)(bB) of the Pension Fund Act*, National Treasury, 4 March 2011
[36] The preamble to Regulation 28
[37] Section 2(c)(iv) of Regulation 28
[38] Ibid
[39] Section 2(c)(viii) of Regulation 28
[40] Section 2(c)(ix) of Regulation 28
[41] Ibid. The Regulation does not define the terms "sustainable" or "ESG".
[42] See note 11
[43] Defined in the Pension Fund Act as a "pension fund organisation".
[44] Section 2(1) of the Pension Fund Act
[45] Initially established by the Government Service Pension Act, 1973 – repealed and replaced by the Government Employees Pension Law, 1996 (as amended)
[46] Section 6(2) of the Government Employees Pension Law, 1996 (as amended)
[47] See the Transnet Pension Fund Act, 1990 (as amended)

> "But in general, investors have been passive stewards, conservative in investment philosophies and how mandates define the relationships."
>
> *- Shuffling Feet: Institutional Investors' Attitudes to Climate Change Portfolio Risks,* SinCo and WWF[49]

(b) Gap between policy and practice revisited: Has Regulation 28 been a catalyst for the ambitious scaling-up of responsible investment by trustees in South Africa?

The revised Regulation 28 has been considered a "global best practice"[50] in that it requires trustees to consider and apply their minds to responsible investment and ESG factors. Effective implementation of Regulation 28 requires significant change – in the approach to investing and ownership, and in the adjustment of policies, mandates, investments and monitoring and reporting systems. But how are trustees faring in practice?

Regulation 28 came into effect on 1 January 2012,[51] and so has probably not been in operation long enough for its implementation or effects to be properly assessed and understood. Research indicates that the Regulation has led to an increased interest in the topic of responsible investing and that most trustees of large[52] pension funds are moving to integrate ESG factors at policy level, or already have some form of policy for responsible investment and the consideration of ESG factors.[53]

The understanding and implementation of Regulation 28 by smaller pension funds is uncertain. While responsible investment and the consideration of ESG criteria are generally articulated at policy level, these may be "partly developed but unevenly implemented at process level"[54] and frequently face "barriers of knowledge gaps and technical skills, metrics and lack of demonstrated success…".[55]

The effectiveness of Regulation 28 and ESG integration is therefore unclear. These barriers include:[56]

(i) The "language of ESG" is still unfamiliar to many trustees.

(ii) Lack of understanding by trustees as to how to plan, implement and monitor the principle-based approach of Regulation 28 relating to ESG factors. The Financial Services Board and National Treasury have yet to release any directives, information circulars or toolkits that assist trustees in this regard. However, they are currently taking part in the Sustainable Returns Project (refer to section 4(C) below) and National Treasury has indicated that it intends for a revised PF 130 to be issued as a draft directive dealing with governance of retirement funds by the end of 2013.[57]

(iii) Material mispricing of ESG factors as a result of a failure to track and analyse, for example, water scarcity risks and carbon emissions at a portfolio level to better understand their effects. While some work is being done by some investors on climate change, a sophisticated appreciation of the consequent systemic risks[58] is lacking.[59]

(iv) "Impact measurement and ESG performance attribution remain an intellectually challenging and operationally complex aspect of sustainable investment practice."[60] Trustees rely on the fullest possible disclosure by portfolio companies of current risks and opportunities. Although South Africa is generally considered a world leader in reporting standards,[61] climate risks are not made publicly available across the board and may also be reported in different ways – this makes understanding, comparisons and benchmarking of the information difficult.[62]

[48]Section 9 of Regulation 28
[49]*Shuffling Feet: Institutional Investors' Attitudes to Climate Change Portfolio and Risks,* May 2013, SinCo and WWF
[50]*Sustainable Investment in Sub-Saharan Africa: Investment Practitioner Views of Sustainable Investment in Private Equity and Asset Management in South Africa, Nigeria, and Kenya,* July 2011, International Finance Corporation, SinCo and RisCura; www.africainvestor.com/article.asp?id=9057, accessed 15 August 2011
[51]See note 20
[52]Not defined in the *Shuffling Feet* paper (See note 49) but this paper does state that its purpose included exploring the policies used by major institutional investors in South Africa by consulting asset owners representing R1,055 billion.
[53]See note 49
[54]Ibid
[55]Ibid
[56]Many of these issues are inter-related, and this paper does not seek to provide an exhaustive or detailed analysis of all relevant barriers.
[57]"2013 Retirement reform proposals for further consultation", 27 February 2013, National Treasury, www.treasury.gov.za/documents/national%20budget/2013/2013%20Retirement%20Reforms.pdf, accessed 13 May 2013; See note 3
[58]These include legal, operational and strategic risks.
[59]See note 49; *Dirty Feet: Portfolio Carbon – Portfolio Risks and Opportunities from the Carbon Intensities of the 40 Largest Listed Companies in South Africa*, Graham Sinclair, Stefano Dell'Aringa and Liesl van Ast, January 2012. Please also see *Carbon and Water Risks for South Africa's Top Companies, Bonds and Equity Funds*, Trucost and the WWF, late 2012 and *Unburnable Carbon: Budgeting Carbon in South Africa*, Carbon Tracker and WWF, late 2012 (See note 12) for work that has been done in this regard.
[60]See note 49
[61]See note 11

> **“Pension funds must integrate [responsible investment] into their investment and ownership practices... and should refer to voluntary codes in so doing. Compliance is necessary and voluntary codes are useful”**
>
> - International Finance Corporation and the Sustainable Returns Project: *Responsible Investment and Ownership: A Guide for Pension Funds in South Africa (final review draft)*[68]

(v) In many cases, while ESG criteria may contribute to value creation in the long term, they may not be financially material within the timescales upon which investment mandates are based or within the period that the market expects performance.[63]

(vi) The costs (perceived and actual) of implementing ESG criteria in decision-making and processes.

(vii) While South Africa has a number of policy[64] and legislative[65] initiatives and commitments that emphasise, among other things, the need to develop our economy sustainably – and should therefore incentivise responsible investment – these sometimes lack the coherence and alignment required to create policy certainty and a dependable environment.[66] This is needed to facilitate buy-in and investor confidence, and accelerate responsible investment practices by trustees. Difficulties (perceived or otherwise) in monitoring implementation and enforcing compliance with these policies and legislative initiatives add to the uncertainty and policy risk.[67]

B. INDUSTRY-LED POLICY FOR RESPONSIBLE INVESTMENT

Accountability and the reaction of the market remain one of the most effective ways of ensuring the implementation and effectiveness of Regulation 28.[69]

The scope of this aspect of the review is limited to a consideration of voluntary, industry-led initiatives in the form of the PRI and CRISA.[70] There is increasing pressure for accountability and transparency, and a demand on trustees from a members perspective to consider ESG factors. Despite this, research indicates that while service providers have been relatively responsive in the push to consider ESG factors,[71] the majority of pension funds in South Africa have not been active in taking up and implementing the principles of the PRI[72] and CRISA.[73]

The principles of the PRI and CRISA reflect good governance and are aligned.[74] CRISA aims to provide the investor community with the guidance needed to give effect to, among other things, the PRI. Similarly, the PRI has expressed its support for CRISA. Both aim to illuminate the financial relevance of ESG criteria, and encourage collaborative engagement to promote acceptance and implementation of ESG criteria.[75]

Although neither code provides a specific set of obligations designed with the intention of being enforced and measured in respect of ESG, committing to the principles does provide a positive indication of the intention of pension funds, and their expectations of asset managers. In addition, committing to voluntary codes (such as the PRI) is an important source of tools and resources, and a way of indicating the seriousness with which the principles of Regulation 28 are being considered and adopted, thereby possibly avoiding further intervention by government.[76]

[62]See note 49
[63]“Overcoming strategic barriers to a sustainable financial system”, undated, PRI
[64]See note 24
[65]See note 25
[66]For example, in the case of energy efficiency. In this regard, see *Overview and Assessment of the EE and Energy Conservation Policies and Initiatives of the Republic of South Africa*, 2012, Deutsche Gesellschaft für Internationale Zusammenarbiet (GIZ) GmbH
[67]This analysis is supported by the findings of research set out in the *Shuffling Feet* paper (See note 49).
[68]See note 3
[69]See note 11
[70]Not within the scope of this paper are other initiatives like the Asset Owners Disclosure Project, Equator Principles, the Carbon Disclosure Project, the Water Disclosure Project, the Emerging Markets Disclosure Project and the International Corporate Governance Network.
[71]See note 49; *The State of Responsible Investment in South Africa,* Ernst and Young and G van der Ahee, January 2013
[72]As at May 2013, four pension funds in South Africa were reported to be signatories to the PRI (www.unpri.org/signatories/signatories/?country=South Africa#asset_owners accessed on 13 May 2013).
[73]“CRISA not getting full support”, 15 February 2013, *MoneyMarketing*, www.moneymarketing.co.za/crisa-not-getting-full-support, accessed on 13 May 2013
[74]‘Code for Responsible Investing in South Africa (CRISA)’, Sanlam, bit.ly/18ogLuC, accessed 23 April 2013
[75]Refer to the guidance document drafted by the PRI South Africa Network Engagement Working Group for clarity on the regulatory framework that governs collaborative engagement, at www.iodsa.co.za/?page=crisa, accessed 23 April 2013; *The State of Responsible Investment*

(I) PRI in Principle and in Practice

The PRI was launched in 2006 and is supported by the United Nations.[77] It is an international network of investors working together to understand the implications of sustainability issues for investors, and providing support to signatories in fulfilling their fiduciary duties by achieving better long-term investment returns.[78]

The PRI sets out a series of non-prescriptive, aspirational principles by which investors can seek to incorporate ESG criteria into decision-making and ownership practices across the various asset classes. These deal with matters including active ownership, appropriate disclosure, collaboration and reporting.

The PRI provides members with practical assistance in the form of implementation support (including case studies, tools and webinars) and a platform for collaborating with an international network of asset owners, asset managers and other service providers.[79] Importantly, the PRI monitors progress and provides feedback on implementation through a PRI Reporting Framework – a global standard for reporting and assessing responsible investment activities applicable to all signatories.[80]

Although PRI signatories include nearly 1,200 of the world's asset owners, asset managers and other service providers representing combined assets under management of approximately US$35 trillion,[81] few South African asset owners have signed to date.[82]

(II) CRISA in Principle and in Practice

Ernst and Young, and the Gordon Institute of Business Science have indicated in a summary of an interview with John Oliphant, the Chair of CRISA, that "with the launch of the CRISA code in 2011, responsible investment has started to become a lot more practical in South Africa".[83]

CRISA is an institutional investor initiative intended to give guidance on how pension funds can give effect to the principles in Regulation 28 and the PRI, and "execute investment analysis, activities and rights so as to promote sound governance and sustainable development".[84]

Some noteworthy points about CRISA:
- There is no mechanism for or cost to becoming a formal signatory.
- The principles apply to both listed and unlisted equity investments.
- The principles provide a good basis against which to discuss ESG expectations and implementation with asset managers.
- Both the pension fund and, if applicable, its asset manager are required to report on the application of CRISA (unless otherwise provided in the mandate).
- It has been endorsed by, among other authorities, the PRI – and efforts have been made to align the reporting requirements of the PRI and CRISA to avoid unnecessary administrative burdens.[85]

[76]See note 75, accessed 23 April 2013
[77]The UNEP Finance Initiative and the UN Global Compact
[78]PRI Handout, April 2013
[79]UN Principles for Responsible Investment, www.unpri.org, accessed 14 May 2013
[80]See note 78
[81]See note 79
[82]Signatories to the Principles for Responsible Investment: South Africa, www.webcitation.org/6GwHaU2Kj, accessed 14 May 2013
[83]Summary of interview with John Oliphant, 2 April 2012, Ernst & Young, www.webcitation.org/6GwHJNsOQ , accessed 23 April 2013
[84]See note 11

Pension funds had to disclose the extent to which they are applying the principles and practice recommendations in CRISA on an “apply or explain” basis by 1 February 2012. “Most role players in the industry do agree with the principles behind CRISA and the change that this code is trying to embed in South Africa’s corporate culture to ensure sustainability,”[86] but few pension funds had made a public commitment to CRISA by this date[87] and the uptake remains limited.[88]

These are some of the challenges:[89]

- Limited awareness of the importance and relevance of ESG criteria among trustees, and reliance on asset managers to take leadership on the implementation of CRISA
- Asset managers’ belief that pension funds should take a more active stance on the implementation of CRISA in order for them to make improved progress in implementing the CRISA principles into their investment processes
- The difficulty in incorporating the CRISA principles into asset managers’ existing investment processes in practice. These include “educating staff, finding reliable data and fairly valuing different companies”[90] and the costs of implementing these changes
- Need for clearer guidelines on how to implement the CRISA principles
- Need for more evidence-based research to make the business case that responsible investment strategies positively affect performance over the long term[91]
- Need for current benchmarks against which companies’ performance is measured to incorporate ESG factors and measurement of performance against those benchmarks
- Need for a widely accepted definition of ESG and reliable and accurate ESG information for assessment presented in a standardised format
- While there is a belief that the exercise of voting rights and engagement with investee companies will positively affect returns, disclosure of these decisions and actions remains limited, making holding pension funds to account difficult. This has led to the publication of the CRISA Practice Note on “Guidance on Disclosure of the Application of CRISA”[92]

[85]“Frequently Asked Questions about CRISA”, Institute of Directors Southern Africa, www.iodsa.co.za/?CRISAFAQ, accessed 23 April 2013
[86]See note 75
[87]“CRISA implementation hangs in balance”, Ann Crotty, 1 February 2012, *Business Report*, www.webcitation.org/6GwI0fGRb, accessed 27 May 2013
[88]Note that the CRISA Committee is currently establishing a process to establish the extent of reporting against CRISA, and therefore compliance with CRISA.
[89]See note 75; “Down to the nitty gritty”, *Today’s Trustee*, December 12/January 2013, www.totrust.co.za/30112012_investment2.htm, accessed 23 April 2013; “Asset managers still mum on their voting”, Ann Crotty, 24 January, *Business Report*, www.webcitation.org/6GwIAFqQS, accessed 27 May 2013; Survey on the Code for Responsible Investing in South Africa, Momentum Investments: Manager of Managers, August 2012; “Spoilt Votes: The landscape of proxy voting at South African asset managers”, Jimmy Whitfield, July 2011, University of Cape Town (article sponsored by RisCura)
[90]‘Down to the nitty gritty’ (See note 89)
[91]See *Carbon and Water Risks for South Africa’s Top Companies, Bonds and Equity Funds Paper and Unburnable Carbon: Budgeting Carbon in South Africa* paper for work that has been done in this regard. (See note 12)

4. GETTING STARTED

Examples of the application of ESG principles in practice and some additional tips and recommendations for trustees

The purpose of this section is to facilitate a discussion around the understanding, application and implementation of ESG criteria in South Africa, and the tools available to assist in this regard.

This section contains two case studies focused on the GEPF and the Metal Industries Benefit Fund Administrators (MIBFA), a note on the work currently being conducted by the Sustainable Returns Project, and some recommendations and tips for trustees to start or further the process of ESG consideration and implementation in their portfolios.

Although the case studies are intended to provide examples of best practice, they should be read while remembering that responsible investing is principle-based. Each pension fund needs to decide on a strategy and process for implementation applicable to its own circumstances and the beneficiaries that it services in accordance with its own fiduciary and statutory duties.

The writer acknowledges that given the brief and scope of this paper, this is by no means a comprehensive list or indication of how trustees can set about implementing ESG principles in their investing in all circumstances. In addition, there are a variety of stakeholders and initiatives not mentioned here that are already involved in responsible investing and whose experiences, research and tools can provide valuable insights for trustees.

A. Climate Change: An ESG Risk

Pension fund trustees may need to consider a number of ESG risks when exercising their duties as managers of fund assets. This paper considers the approach of two pension funds to one of these risks, namely, climate change.

Our knowledge and understanding of climate change risk is continually increasing. Scientific research into ecosystem health and climate-related events, such as droughts and flooding, is providing mounting evidence of the risk of climate change. South Africa, which is a water-stressed country, is especially vulnerable to the impacts of climate change. In fact, the effect of climate change on South Africa is already a measurable reality.[93]

Our better understanding of climate change risk has enabled policymakers and the business community alike to begin to address the problems that it will cause. In business, climate change will impact on companies' operations, revenues and costs. Investors in these companies will also be affected. As Adam Seitchik, James Hawley, Andy Williams and researchers in the field of responsible investment point out, because of the portfolio approach to investing and longer-term holding strategies, many institutional investors are universal owners, owning a share of the highly diversified economies in which they invest. As a result, "[t]heir returns and consequently their ability to meet their fiduciary obligations depend to a critically large extent on the performance of the economy as a whole". Investors therefore have "a strong vested interest in public policy and private activity that lowers the global risk of climate-related economic disruption".[94]

Pension funds can take a number of approaches to reduce ESG risks. These include engagement, ESG integration, negative screening and positive screening. These approaches are explained in Table 1.

[92]www.asisa.org.za/index.php/mysearch.html?searchword=crisa+practice+note&ordering=&searchphrase=all. Accessed 29 April 2013
[93]National Climate Change Response White Paper, The Government of the Republic of South Africa, October 2011

TABLE 1: ESG INVESTMENT APPROACHES*

ESG INVESTMENT APPROACH	DEFINITION	EXAMPLE
Negative screening	A process which excludes companies as potential investments by taking into account their corporate involvement in unsuitable industries. Negative screening results in avoidance of investments in targeted companies, industries, and countries.	Islamic banking excludes investment in the gambling and alcohol sectors, among other investment themes.
Positive screening	A process which includes companies as potential investments because they promote social and/or environmental sustainability. Suitability often relies upon scoring a company against some predetermined criteria or analysing performance against the company's industry peers to find the "best-in-class".	GEPF's Isibaya investments aim to finance emerging sectors of the South African economy and promote economic growth through infrastructure investments in Africa.
Engagement, including proxy voting and collaboration	Engagement involves investor interactions with company managers and directors to signal concerns, understand how concerns are being managed and communicate steps deemed necessary for improvement.	Engagement interactions can range from relatively informal telephone calls and emails to sending letters and meeting with managers or directors, to exercising voting rights.
Integration	ESG integration refers to the use of ESG data in determining company valuations and requires making a link between extra financial information and financial performance. Integration means that ESG factors which influence investment risks and returns are incorporated into investment analysis and decision-making.	The 2008 credit and financial crisis caused mainstream investors to become increasingly aware of ESG factors as an important source of insight into the long-term viability of companies.

** From WWF internal reports and Principal Officers Association "Making your retirement fund CRISA compliant" 2012 training*

B. Two Case Studies: Addressing Climate Change Risks

The MIBFA represents the interests of more than 400,000 active members in the Engineering Industries Pension Fund and Metal Industries Provident Fund. MIBFA recently made a R1 billion investment in the Mergence Renewable Energy Debt fund, stating that "the investment is also in line with the changes to Regulation 28 of the Pensions Fund Act, helping to mobilise funds into projects that promote environmental, social and governance outcomes".[95]

The GEPF is the largest pension fund in South Africa, with assets under management of over R1 trillion. According to the GEPF, "climate change and water scarcity are two of the main drivers that we need to seriously address in the transformation of the South African (and global) economy into one that is resource efficient, lower in carbon emissions, resilient and equitable".[96]

A selection of the actions taken by each of these pension funds to address climate change risk is detailed in Table 2.

[94]Hawley, J. and Williams, A, April 2006, Universal Owners: Challenges and Opportunities, introductory remarks at the Universal Ownership Conference, Saint Mary's College, Moraga, California
[95]"Metal workers' funds invest R1bn in renewable energy", 24 April 2013, *Business Day*, www.bdlive.co.za/business/energy/2013/04/24/metalworkers-funds-invest-r1bn-in-renewable-energy, accessed 27 May 2013

TABLE 2: EXAMPLES OF ACTIONS TAKEN BY THE GEPF AND THE MIBFA IN SOUTH AFRICA TO ADDRESS CLIMATE CHANGE RISK

FUND	TYPE OF FUND	SELECTION OF ACTIONS TAKEN TO ADDRESS CLIMATE CHANGE RISK
Government Employees' Pension Fund (GEPF)[97]	Defined benefit	ESG integration: • Estimation of carbon and water footprint of selected equity and bond portfolio[98] • Estimation of fossil fuel reserves in portfolio[99] Positive screening: • R5bn investment in Industrial Development Corporation green bond which will invest in renewable energy generation and energy-efficiency projects in South Africa[100] Engagement: • Collaboration with WWF on research to raise awareness among institutional investors and financial market regulators about climate change risks and opportunities[101]
MIBFA, representing the Engineering Industries Benefit Fund and the Metal Industries Provident Fund[102]	Defined contribution	Positive screening: • R1bn investment in Mergence Renewable Energy Debt Fund which will provide debt financing to Independent Power Producers under the government's Renewable Energy Independent Power Producers Procurement (REIPPP) programme[103]

C. The Sustainable Returns Project[104]

Stephanie Pfeifer, executive director of the Institutional Investors Group on Climate Change, has stated that for progress to continue to be made with responsible investment, investors must be provided "with tools to take further action".[105]

The Sustainable Returns Project is an initiative launched in December 2011 aimed at helping pension funds respond effectively to the business case for responsible investment[106] and to "integrate ESG considerations into the mainstream of retirement industry investment practices".[107] It is noteworthy for the following reasons:

- The project is focused on the context of southern Africa and the requirements of Regulation 28 and CRISA.
- The initiative is industry-led, has and continues to involve broad consultation with industry bodies, investment practitioners and pension funds, and has made use of experts to consider international and local best practice and trends. The project is supported by the International Finance Corporation and various stakeholders representing government and the regulators (National Treasury and the Financial Services Board), industry associations (including the Principal Officers Association of South Africa, the Association for Savings and Investment South Africa, Banking Association of South Africa, Financial Planning Institute, Institute of Directors and Pension Lawyers Association), industry initiatives (the PRI and CRISA), pension funds (including GEPF and the Telkom Pension Fund) and organised labour.
- It aims to respond to a need for capacity building and investment education by providing information, frameworks, training and tools to support trustees and their service providers in implementing the principles of Regulation 28 and CRISA.[108]

[96] *Navigating Muddy Waters: Securing Investment Returns under Carbon and Water Constraints* (See note 12)
[97] "Who is GEPF", www.gepf.gov.za/index.php/about_us/article/who-is-gepf, accessed 16 May 2013
[98] *Carbon and Water Risk for South Africa's Top Companies, Bonds and Equity Funds: How Corporate Emissions Expose Investors to Carbon Taxes and Thirsty Assets are Vulnerable to Climate Change Impacts* (See note 12)
[99] *Unburnable Carbon: Budgeting Carbon in South Africa* (See note 12)
[100] "IDC concludes R5bn 'green bond' with PIC", 7 November 2012, *Engineering News*, www.webcitation.org/6GwJGOxzN, accessed 14 May 2013
[101] See note 97
[102] See website of the Metal Industries Benefit Funds Administrators, www.mibfa.co.za/history.aspx, accessed 16 May 2013. The writer was unable to meet with representatives of the MIBFA to discuss this initiative.
[103] See note 95
[104] For more information, please contact Samantha Jagdessi at samantha@sustainablereturns.org.za.
[105] Quoted in the *Shuffling Feet* paper (See note 49).
[106] See note 3
[107] Sustainable Returns Project handout, undated
[108] The project is intended to have a number of outputs. These include a manual aimed at educating and empowering trustees (the foreword for which is to be provided by the Minister of Finance) and developing training

D. Recommendations And Tips

Below are a series of recommendations and tips for trustees to consider when implementing ESG principles. The list is not comprehensive and should be considered in conjunction with applicable standards, codes of good practice, guidelines and toolkits (such as those provided by the PRI, CRISA and the Sustainable Returns Project).

The applicability of each recommendation will need to be assessed on a case-by-case basis to judge its appropriateness for the relevant organisation, and to assess whether the costs involved in implementation are justifiable. Many of these issues will be a matter of negotiation between the trustees and their asset managers, and a subject for ongoing assessment over the life of this relationship.

RESOURCE	GENERAL RECOMMENDATIONS: POSSIBLE NEXT STEPS	RECOMMENDATIONS TO ADDRESS WATER SCARCITY AND CARBON CONSTRAINTS: POSSIBLE NEXT STEPS
Based on recommendations proposed in the *Shuffling Feet* paper[109] (included in the *Navigating Muddy Waters* report series[110]) and the Sustainable Returns Project guide[111]	• Develop an investment policy statement that considers ESG, active ownership and conflicts of interest • Consider how the companies you or your asset manager invest in incorporate sustainability and ESG issues • Consider whether your asset manager incorporates sustainability and ESG issues in their philosophy and investment process • Make Use of collaboration and mutual learning, and existing work, research, policy statements and toolkits in respect of responsible investment	• Provide climate- and water-related criteria in investment mandates and offer investment mandates based on long-term performance • Identify assets that contribute most to portfolio exposure from a climate risk perspective – develop processes to monitor and regularly assess how asset allocations contribute to carbon and water risks embedded in portfolios, and be more transparent in the reporting and verification of these risks (e.g. consider making investment policy statements publicly available and disclosing how ESG criteria have been applied in investment decisions and ownership practices) • Require increased monitoring, reporting and verification of carbon and water exposure through investment engagement and strengthen active ownership activities (e.g. engage at least annually with companies in the portfolio that have material climate risk exposure, check that you have a policy that details how you will exercise your ownership responsibilities, or how you wish your asset manager to exercise these on your behalf) • Require that service providers benchmark carbon and water performance of portfolio assets against sector peers

courses and a set of tools for practical support in implementing responsible investing.
[109]See note 49
[110]See note 12

RESOURCE	GENERAL RECOMMENDATIONS: POSSIBLE NEXT STEPS	RECOMMENDATIONS TO ADDRESS WATER SCARCITY AND CARBON CONSTRAINTS: POSSIBLE NEXT STEPS
Based on the International Corporate Governance Network (ICGN) Model Mandate Initiative[112]	Examples of requirements that can be included in the mandate with asset managers include: • Reporting systems and provisions for non-compliance with the mandate, e.g. ongoing due diligence monitoring of ESG criteria connected to termination provisions in the mandate • Specific examples of positive behaviour, e.g. voting in accordance with the aims set out in the investment policy statement and involvement with industry bodies and initiatives. The mandate should include sufficient voting guidelines	

[111]See note 3
[112]"ICGN Model Mandate Initiative: Model contract terms between asset owners and their fund managers", March 2012, ICGN. Effective use of the contractual mandate with asset managers is a fundamental tool for trustees to ensure effective implementation of ESG criteria. The Model Mandate Initiative provides a set of model contract terms proposed by the ICGN for use between asset owners and their asset managers, and is one example of terms that can be used as a starting point for negotiating and regulating this relationship. The ICGN Model Mandate Initiative itself should be reviewed for a complete analysis of its recommendations.

ABOUT WWF

WWF is one of the world's largest and most experienced independent conservation organisations, with over five million supporters and a global network active in more than 100 countries. WWF's mission is to stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature, by conserving the world's biological diversity, ensuring that the use of renewable natural resources is sustainable, and promoting the reduction of pollution and wasteful consumption.

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Aimée Girdwood is the managing partner of Energy & Sustainable Development Solutions, an independent energy and sustainable development advisory and legal consultancy. Aimée is an authority on the laws and regulations affecting responsible investing, environmental sustainability, climate change, integrated and sustainability reporting, clean energy and energy-efficiency initiatives, and green building.

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Why we are here
To stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature.

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