United States Government Accountability Office
Report to Congressional Requesters

May 2018

RETIREMENT PLAN INVESTING

Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful

GAO-18-398

GAO Highlights

Highlights of GAO-18-398, a report to congressional requesters

May 2018

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Why GAO Did This Study

ESG factors have emerged as a way for investors, such as retirement plans, to capture information on potential risks and opportunities that may otherwise not be taken into account. For example, climate change is expected to have widespread impacts according to a key federal study and may pose significant financial risks for long term investors, such as retirement plans that must manage risk to provide benefits for many years to come. A number of large plans in other countries have adopted ESG strategies, but less is known about their use among U.S. plans. Given the emerging use of ESG factors, GAO was asked to examine how such factors are used by retirement plans in the United States and other countries.

GAO examined: (1) the use of ESG factors by U.S. retirement plans, (2) the use of ESG factors by selected retirement plans in other countries, and (3) DOL's guidance on the use of ESG factors by private sector U.S. retirement plans. GAO reviewed available private sector survey data and other documentation and interviewed government officials, asset managers, and plan representatives in the United States, France, the Netherlands, and the United Kingdom—from retirement plans that were identified as leading examples in the use of ESG factors.

What GAO Recommends

GAO is making two recommendations to DOL, including that DOL clarify whether the liability protection offered to qualifying default investment options allows use of ESG factors. DOL neither agreed nor disagreed with GAO's recommendations.

View GAO-18-398. For more information, contact Charles A. Jeszeck at (202) 512-7215 or jeszeckc@gao.gov.

What GAO Found

Few retirement plans in the United States incorporate environmental, social, and governance (ESG) factors into their investments according to available data. ESG factors that may affect investment returns include climate risk, executive compensation, and workplace safety issues among others. According to GAO's interviews with seven asset managers, inconsistent data and regulatory uncertainty create challenges to incorporating ESG factors in plan investment management. However, those plans considering ESG factors use various strategies to do so (see figure). Asset managers and plan representatives said they incorporate ESG factors to better manage risks and improve performance.

Strategies Used to Incorporate ESG Factors into Investment Management

Source: GAO analysis of documentation from CFA Institute and other sources. | GAO-18-398

The retirement plans GAO reviewed in France, the Netherlands, and the United Kingdom (UK) reported using integration and other strategies to incorporate ESG factors across their investments, particularly to address the risk of climate change. For example, the UK's National Employment Savings Trust—a defined contribution plan—used an ESG integration strategy in developing its default fund for participants who are automatically enrolled and do not select another investment. As part of their ESG strategies, representatives from these plans described targeted efforts to address climate risk related to financial performance. These representatives also said they are subject to governmental policies that encourage plans to address ESG risks.

In the United States, the Department of Labor's (DOL) guidance for private sector plans identifies ESG factors as proper components of investment analysis, but does not fully address uncertainties plans may face. In particular, sponsors of defined contribution plans face uncertainty about whether they may use ESG factors in a qualifying default fund—a widely used option in which a fiduciary is generally not liable for investment losses. DOL's mission includes assisting and educating plan fiduciaries. Providing clearer information about how to use ESG factors would help fiduciaries better understand whether and how to consider these potentially material risks. DOL is also considering steps to collect data on the use of ESG factors by retirement plans.

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Abbreviations

ABP	Stichting Pensioenfonds ABP
APG	Algemene Pensioen Groep
DNB	Dutch National Bank
DOL	Department of Labor
EBSA	Employee Benefits Security Administration
ERISA	Employee Retirement Income Security Act of 1974
ESG	environmental, social, and governance
NEST	National Employment Savings Trust
OECD	Organisation for Economic Co-operation and Development
PRI	Principles for Responsible Investment
QDIA	Qualified Default Investment Alternative
RAFP	Régime de Retraite Additionnelle de la Fonction Publique
SASB	Sustainable Accounting Standards Board
TPR	The Pensions Regulator
TSP	Thrift Savings Plan
UK	United Kingdom
US SIF	The Forum for Sustainable and Responsible Investment

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May 22, 2018

The Honorable Brian Schatz
United States Senate

The Honorable Gerald Connolly
United States House of Representatives

The Honorable James Langevin
United States House of Representatives

Retirement plans have investment timeframes spanning decades and must manage investment risks to provide benefits for workers for many years to come. Climate change has increasingly been recognized as an important long-term investment risk by some retirement plans and other investors because it is expected to have widespread economic impact. Climate-related impacts have already cost the U.S. economy billions of dollars, and these costs are expected to rise in the future, according to the Office of Management and Budget and the U.S. Global Change Research Program.[1] The use of environmental, social, and governance (ESG) factors has emerged as a way for investors, such as retirement plans, to capture information on climate change and other potential risks and opportunities that may otherwise not be taken into account in financial analysis, which investors use to select and manage investments. In addition to climate change, high-profile events involving large publicly-traded companies in the financial services and oil and gas production sectors have highlighted the potential negative impact on financial performance when ESG factors, such as cybersecurity and accident and safety management, are not well-managed. Whether or not retirement plans consider the projected impacts from climate change and other ESG risk factors could affect investment returns and, in turn, the financial health of retirees. To address such risks, a number of large retirement plans in Europe have adopted ESG investment strategies. Less is known about the extent to which ESG strategies are used by U.S. retirement

[1] As we reported in September 2017, extreme weather and fire events cost the federal government over $350 billion over the preceding decade and these costs will likely rise in the future as the climate changes, according to the Office of Management and Budget and the U.S. Global Change Research Program, respectively. See GAO, *Climate Change: Information on Potential Economic Effects Could Help Guide Federal Efforts to Reduce Fiscal Exposure*, GAO-17-720 (Washington, D.C.: Sept. 28, 2017).

plans, particularly private sector retirement plans which are overseen, in part, by the Department of Labor (DOL).

You asked us to review retirement plans' use of ESG factors in investment management. This report examines (1) the use of ESG factors by retirement plans in the United States, (2) the use of ESG factors by selected retirement plans in other countries, and (3) DOL's guidance on the use of ESG factors by private sector retirement plans in the United States.

To examine retirement plans' use of ESG factors in the United States, we reviewed available surveys of plans or plan service providers that included relevant data. We identified two reports based on surveys with relatively large sample sizes that only included defined contribution plans.[2] We also reviewed other reports based on survey data that included both defined contribution and defined benefit plans, but which had substantially smaller sample sizes and/or included other types of investors, such as endowments and foundations.[3] In addition, we conducted a literature review of studies that analyzed the financial performance of ESG strategies in the United States and were published in peer-reviewed academic journals or publications from 2012 through 2017. The literature review included 11 studies, of which 9 studies conducted empirical analyses of investment scenarios with a collective total of 1,288 scenarios analyzed. (For more information on the studies we examined with data on the prevalence of the use of ESG factors, see appendix I.)

We also conducted structured interviews with asset managers for retirement plans (i.e., service providers that manage the investment of plan assets) and additional interviews with ESG service providers (such as firms that provide research and ratings on ESG factors) to gather information on the types of ESG strategies used by retirement plans, the goals of such strategies, and their experience with implementation. We contacted asset managers ranked to be among the largest 10 in 2016

[2] A defined contribution plan, such as a 401(k), is a retirement plan in which participants accumulate savings in an individual account based on employee and/or employer contributions and the investment returns earned on the account.

[3] Unlike in a defined contribution plan, in a defined benefit plan assets are managed collectively by the plan and a participant is typically provided a monthly benefit upon retirement based on a formula that takes into account factors such as an employee's salary, years of service, and age at retirement.

(the most recent available data at the time of our review), according to *Pensions & Investments*, and 7 of the 10 agreed to participate in our structured interviews.[4] In addition, we interviewed representatives of six public sector retirement plans and reviewed plan documentation on their use of ESG factors in investment management. These included the five largest U.S. public sector retirement plans based on the amount of assets under management for 2016 as reported by *Pensions & Investments*—one federal plan, three state plans, and one municipal plan—and one smaller state plan, at the recommendation of the National Association of State Retirement Administrators, which established a task force to study ESG investing.

To examine how retirement plans in other countries incorporate ESG factors, we reviewed documentation and interviewed representatives from selected plans in France, the Netherlands, and the United Kingdom, as well as government officials, service providers, and stakeholders. To select these plans, we conducted an initial review of retirement plans in countries highlighted for their use of ESG factors in available literature and consulted with experts at the Organisation for Economic Co-operation and Development and the Council of Institutional Investors. The selected plans included two hybrid defined benefit plans and one defined contribution plan that each use different ESG strategies.[5]

To examine DOL's guidance for retirement plans' use of ESG factors in their investment management, we reviewed the relevant DOL guidance and other documents published by DOL. This included the interpretive bulletins that document DOL's interpretation of the relationship between fiduciary responsibilities, such as the duty to act solely in the interest of plan participants and prudently invest plan assets, and potential use of ESG factors. We also interviewed DOL officials to discuss interpretive bulletins and the status of potential changes to information collected from retirement plans. In addition, we included questions about the interpretive

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[4] *Pensions & Investments* is an industry publication for institutional investors, such as retirement plans. See: Pensions & Investments, "Money Managers/Managers by Tax-Exempt Institutional," in *P&I Research Center*, accessed June 26, 2017, http://researchcenter.pionline.com/rankings/money-manager/specialreports/te-instl?year=2017. The *Pensions & Investments* ranking was based on assets under management for U.S. institutional tax-exempt clients, which include retirement savings plans, endowments, and foundations.

[5] Hybrid defined benefit plans generally allow adjustments to both contributions and benefits depending on the plan's funding level. Upon retirement, the plan typically provides monthly income to participants.

bulletins in our structured interviews with asset managers to gather information on their understanding and perspectives on DOL's guidance.

We conducted this performance audit from January 2017 to May 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Investors are reported to increasingly use environmental, social, and governance (ESG) factors to assess a wider range of risks and opportunities that may otherwise not be taken into account in financial analysis.[6] ESG factors like climate change impacts, workplace safety, and executive compensation may be considered relevant to a company's expected financial performance and thereby to its value to shareholders. For example, some investors believe that companies with good corporate governance practices—like well-designed incentives in how executives are compensated—are better managed and will perform better financially over time and thereby deliver better long-term value to shareholders. Several organizations focused on investment issues like the Sustainable Accounting Standards Board (SASB), the CFA Institute, and the United Nations-supported Principles for Responsible Investment (PRI) have identified examples of ESG factors, as shown in table 1.[7]

[6] For example, see US SIF: The Forum for Sustainable and Responsible Investment, *Report on US Sustainable, Responsible and Impact Investing Trends* (2016) and the United Nations supported Principles for Responsible Investment (PRI) 2017 Annual Report.

[7] SASB is a U.S. non-profit organization with a mission of developing and disseminating sustainability accounting standards. SASB aims to integrate its standards into disclosures which must be filed by publicly-listed companies with the U.S. Securities and Exchange Commission. The CFA Institute is a membership organization that seeks to set professional standards for investment management practitioners and broadly engage other finance professionals through their interest and interactions with the investment management industry. The PRI is a non-profit organization supported by the United Nations that works to understand the investment implications of ESG factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions.

Table 1: Examples of Environmental, Social, and Governance Factors

Environmental	Social	Governance
Climate change impacts and greenhouse gas emissions	Labor standards	Board composition
Energy efficiency	Human rights	Executive compensation
Renewable energy	Employee engagement	Audit committee structure
Air, water, or resource depletion or pollution	Customer satisfaction	Bribery and corruption
Waste management	Community relations	Whistleblower programs
Biodiversity impacts	Data protection and privacy	Lobbying
	Gender and diversity	Accident and safety management

Source: GAO analysis of documentation from the CFA Institute, Sustainable Accounting Standards Board, and the Principles for Responsible Investment. | GAO-18-398

While terminology is not consistently defined in the industry, for purposes of this report we focus on the use of ESG factors in investment management where these factors are considered to be material to an investment's financial performance.[8] This approach differs from other approaches that prioritize ethical or moral goals and may focus on divesting from certain companies or products based on such criteria. Some issues may be important to investors for moral or ethical reasons, but they may not be material to an investment's financial performance. Materiality generally refers to issues that an investor may reasonably consider to significantly affect the financial performance of an investment.[9]

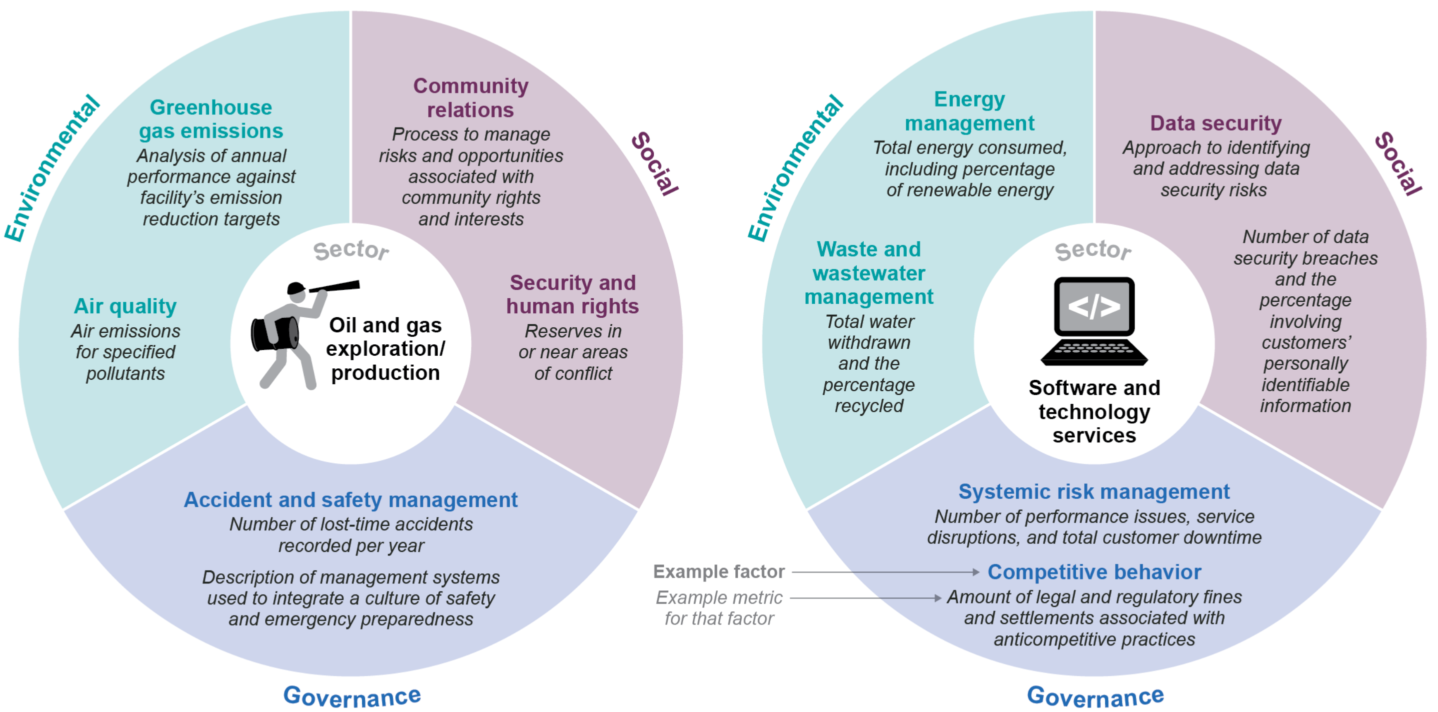
Whether a particular ESG factor is considered material by investors may vary by sector of the economy. To illustrate, figure 1 displays various

[8] Various terms such as responsible investing, sustainable investing, and socially responsible investing can be used to describe investment strategies that may focus on either or both financial performance or ethical or moral goals. In this report, we focus on the use of ESG factors where it is considered to be material to financial performance and not in the context of achieving non-financial objectives.

[9] The materiality standard, as articulated by the U.S. Supreme Court for disclosure of information under the federal securities laws, provides that information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to vote or make an investment decision, or, put another way, if the information would alter the total mix of available information. *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). The Securities and Exchange Commission generally requires publicly-traded companies to disclose in periodic reports, among other things, known trends, events, and uncertainties that are reasonably likely to have a material effect on the company's financial condition or operating performance through annual and other periodic filings.

ESG factors identified as material by SASB for the oil and gas exploration/production sector and the software and information technology services sector. For companies in the oil and gas exploration/production sector, poor accident and safety management practices pose a risk that could negatively affect financial performance. Companies in the software and information technology services sector, meanwhile, face systemic risk management issues regarding the number of service disruptions and the total amount of customer downtime.

Figure 1: Examples of Environmental, Social, and Governance (ESG) Factors Identified as Being Material for Two Sectors



Source: GAO analysis of Sustainable Accounting Standards Board information. | GAO-18-398

Note: These factors were determined to be material in that they are expected to significantly affect the financial performance of an investment.

Climate change may be a particularly important ESG factor for long-term investors in the United States, such as retirement plans. Indeed, some of the largest asset managers in the United States have made climate risk and related disclosures a key engagement priority—that is, an issue they focus on when filing or voting on shareholder resolutions and meeting with management of companies held in their investment portfolios. As we reported in 2017, national-scale studies have found that climate change could result in significant negative economic effects in the United States, and some effects will likely increase over time for most of the sectors analyzed.[10] Similarly, a 2017 report by the Environmental Protection Agency (EPA) projected considerable financial losses from climate change impacts that vary by economic sector.[11] Certain sectors, such as energy and transportation, may be impacted by a transition towards a lower-carbon economy and away from a heavy reliance on fossil fuel energy, driven by potential changes in consumer preferences or taxes on carbon emissions. For companies and their investors, such a transition could result in assets that become "stranded," that is, assets that, due to a change in the marketplace, experience a premature devaluation resulting in a loss of value for investors.[12] In the energy sector, for example, changes due to climate-related policies or widespread adoption of lower-carbon technologies could limit future demand for fossil fuels and thereby lower the value of fossil fuel company reserves. Retirement plans may be vulnerable to these and other climate risks given their direct and indirect investments across economic sectors as well as their longer investment time horizons.[13]

The Relationship between ESG Factors and Financial Performance

Academic research on the performance of investments incorporating ESG factors suggests that such factors can be a valid financial consideration, both in the aggregate and as individual factors. The vast majority (88 percent) of the scenarios in studies we reviewed that were published in peer reviewed academic journals between 2012 to 2017 reported finding a neutral or positive relationship between the use of ESG information in investment management and financial returns in comparison to otherwise

[10] GAO-17-720.

[11] Environmental Protection Agency, *Multi-Model Framework for Quantitative Sectoral Impacts Analysis: A Technical Report for the Fourth National Climate Assessment* (May 2017).

[12] For more information on stranded assets from climate change, see: Richard Baron and David Fisher, *Divestment and Stranded Assets in the Low-carbon Transition* (Paris, France: Organisation for Economic Co-operation and Development, Oct. 28, 2015).

[13] For more information on how climate change may pose a risk to retirement plans, see: Mercer, *Investing in a Time of Climate Change* (2015).

similar investments.[14] When considered independently, environmental, social, and governance factors were each found to have either a neutral or positive relationship with financial performance in over 90 percent of the scenarios. In addition to our literature review, a 2015 meta-analysis, which reported aggregate evidence from more than 2,000 empirical studies, similarly found that 90 percent of the studies reported finding a neutral, positive or mixed (i.e., non-negative) relationship between incorporating ESG factors and financial performance.[15] Further, a 2017 study commissioned by DOL also reported that while some investors may continue to perceive that incorporating ESG factors entails accepting lower investment performance, its review of academic literature suggests that incorporating ESG factors generally produced investment performances comparable to or better than non-ESG investments.[16]

Growth in the Use of ESG Factors by Investors

Investors in the United States, in general (i.e., not limited to retirement plans), are increasingly incorporating ESG factors into their investment management, according to US SIF: The Forum for Sustainable and Responsible Investment (US SIF). For example, the use of ESG factors by U.S. investors continued to grow from 2014 to 2016, according to US

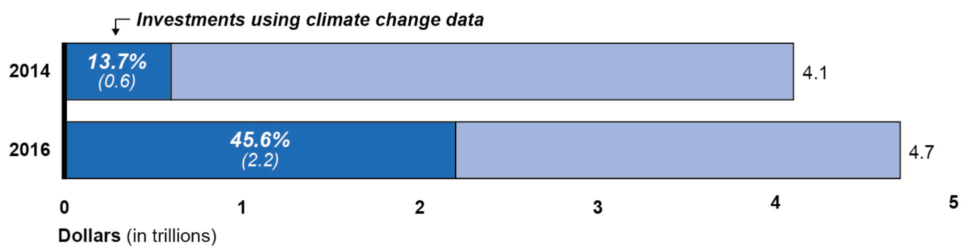
[14] Nine of the 11 studies included in our literature review analyzed multiple investment scenarios to assess the impact of incorporating ESG factors on financial performance for otherwise similar investments. In total, these studies analyzed 1,288 different scenarios. Of these, 254 scenarios analyzed the relationship between an aggregate ESG score and financial performance with the number of scenarios in each study that ranged from 3 to 87. The remaining scenarios assessed the relationship of individual factors or the materiality of the factors with financial performance.

[15] We reviewed the studies included in the 2015 meta-analysis to ensure that none of the studies were duplicated in our review of the academic literature and found that due to the limited overlap in the timeframes of the two reviews, none of the same studies were included in meta-analysis and our review. For meta-analysis see Gunnar Friede, Timo Busch, and Alexander Bassen, “ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies,” *Journal of Sustainable Finance & Investment*, vol. 5 no. 4 (2015).

[16] The DOL-commissioned study included research published between 2006 and 2016. See Ogechukwu Ezeokoli,.et al., Summit Consulting, LLC, *Environmental, Social, and Governance (ESG) Investment Tools: A Review of the Current Field* (Washington, D.C.: Dec. 2017).

SIF surveys.[17] Specifically, the amount of U.S.-based assets under management by institutional investors (including retirement plans) who considered ESG factors represented about $4.7 trillion in 2016—an increase of about 14 percent from the amount US SIF reported in 2014, when adjusted for inflation and expressed in 2016 dollars (see fig. 2). The number of investment funds, such as mutual funds and exchange traded funds, incorporating ESG factors in investments grew 12 percent over the same period. In total, the amount of assets under management by both institutional investors and money managers who considered ESG factors accounted for about one-fifth of all investments under professional management reported by US SIF in 2016 compared to about one-sixth in 2014. Furthermore, the amount of assets under management by institutional investors in the United States that incorporate climate risks increased from about $600 billion to about $2.2 trillion from 2014 to 2016 (expressed in 2016 dollars).

Figure 2: Amount of U.S. Based Assets of Institutional Investors in which Environmental, Social, and Governance (ESG) Factors, Including Climate Change, Are Incorporated, 2014 to 2016, in 2016 Dollars



Source: GAO analysis of data from US SIF: The Forum for Sustainable and Responsible Investment. | GAO-18-398

Note: Percentages may not tie due to rounding.

The use of ESG factors also has grown considerably in other countries. According to the *Global Sustainable Investment Review*, by US SIF and other partner organizations, the amount of global assets invested using ESG factors increased from $18.3 trillion in 2014 to $22.9 trillion by

[17] The US SIF data are based on a survey of asset managers and secondary research using fund prospectus documents, Securities and Exchange Commission filings, and other documentation. Through this research, US SIF identified 300 asset managers and 1,043 community investing institutions, such as banks and credit unions, which reported incorporating ESG factors into their investment management for U.S. domiciled assets. See US SIF Foundation, *Report on US Sustainable, Responsible and Impact Investing Trends* (2016).

2016.[18] Likewise, the number of PRI signatories, including retirement plans and other investors and asset managers, grew from 100 signatories in 2006 to over 1,900 by 2018, according to PRI. In becoming a signatory to the PRI, members commit to following six principles based on incorporating ESG factors into investment management. Of the roughly 1,900 signatories, more than 1,500 are based outside of the United States, including more than 900 signatories based in countries in the European Union. According to the PRI, European Union countries have been directed to require workplace retirement plans to adopt an ESG framework to assess ESG risks, including climate change and stranded assets, by the end of 2018.[19] Indeed, across regions, PRI reported that Europe represented the largest portion of assets managed by PRI signatories that were invested using ESG factors.

Differences in Retirement Plan Type: Defined Benefit and Defined Contribution

ESG factors may be used in the investment management of both defined benefit and defined contribution retirement plans. In a defined benefit plan, a participant is typically provided a monthly benefit upon retirement based on a formula that takes into account factors such as an employee's salary, years of service, and age at retirement. Assets in a defined benefit plan are managed collectively by the plan on behalf of participants. In a defined contribution plan, such as a 401(k), participants accumulate retirement savings in an individual account based on employee and/or employer contributions, and the investment returns earned on the account. Rather than managing assets collectively, as in a defined benefit plan, participants in a defined contribution plan are provided a menu of investment options to select from by the plan. To increase participation, employers sponsoring a defined contribution plan may choose to automatically enroll eligible workers.[20] As part of automatic enrollment, plan sponsors—absent a specific choice by the plan participant—choose an investment option in which to invest contributions on the plan participant's behalf, known as a default investment option. In 2007, the

[18] Global Sustainable Investment Alliance, *2016 Global Sustainable Investment Review* (2016).

[19] This action was directed through the European Union's revised Institutions for Occupational Retirement Provision Directive, according to PRI. As defined previously, stranded assets are those that, due to a change in the marketplace, experience a premature devaluation resulting in a loss of value for investors.

[20] The Pension Protection Act of 2006 included provisions to encourage participation by allowing defined contribution plans to automatically enroll participants and place them in a default investment option if participants do not actively select another option.

Department of Labor (DOL) issued final regulations on the appropriateness of designating default investment options that, among other things, include a mix of asset classes consistent with capital preservation, long-term capital appreciation, or a blend of both. In particular, DOL specified criteria for qualified default investment alternatives (QDIA) that would provide legal protection for plan fiduciaries from liability due to investment losses that occur as a result of investing contributions on behalf of participants.[21]

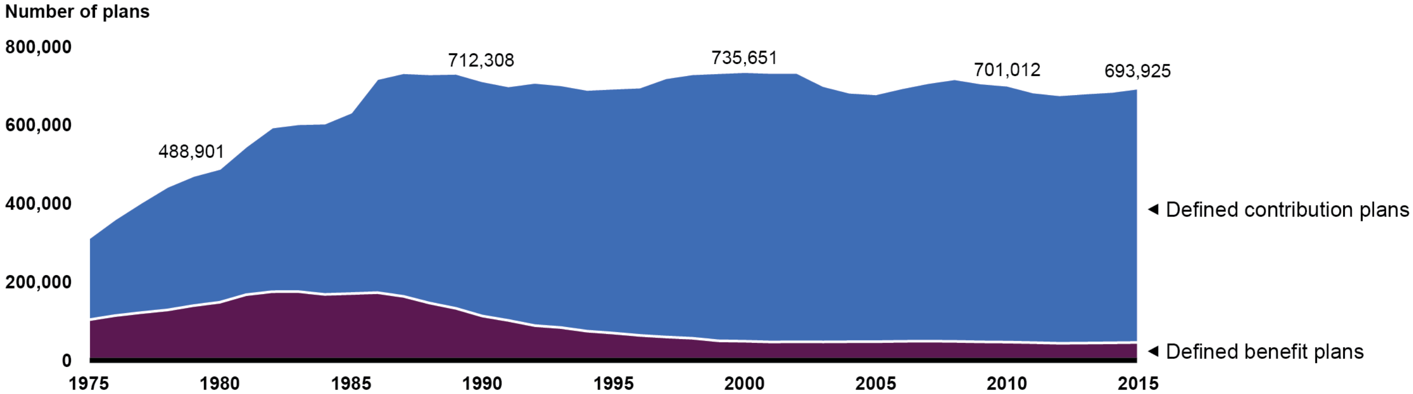
As we reported in 2017, over the past 40 years, there has been a significant shift in the types of retirement plans offered by U.S. private sector employers, who have increasingly moved from offering defined benefit plans to offering defined contribution plans as their primary retirement plans.[22] As shown in figure 3, defined contribution plans have become the dominant employer-sponsored plan type in the private sector, not only in number but in the extent to which these plans are primary retirement benefits for individual workers. In 1975, there were about 103,300 defined benefit plans, compared with about 207,700 defined contribution plans, many of them supplemental plans. By 2015, the number of defined benefit plans had decreased to about 45,600, while the number of defined contribution plans had increased to more than 648,200.[23]

[21] See 29 C.F.R. § 2550.404c-5.

[22] GAO, *The Nation's Retirement System: A Comprehensive Re-Evaluation Is Needed to Better Promote Future Retirement Security*, GAO-18-111SP (Washington, D.C.: Oct. 18, 2017).

[23] The number of plans is an imperfect indicator of the relative breadth of coverage of defined contribution plans versus defined benefit plans because some plans cover a very small number of participants, whereas other plans cover hundreds of thousands of participants. However, totaling the number of participants across all plans would also produce an inaccurate indicator of coverage because often the same individuals would be counted multiple times. Defined contribution plans hold a larger amount of assets than defined benefit plans—$5.3 trillion compared to $2.9 trillion as of 2015 according data from DOL.

Figure 3: Total Number of Private Sector Defined Benefit and Defined Contribution Retirement Plans in the United States, 1975-2015



Source: Form 5500 data from the U.S. Department of Labor. | GAO-18-398

Oversight of Retirement Plans in the United States

In the United States, private sector retirement plans' investment decisions generally must comply with the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). ERISA prescribes standards for fiduciaries of defined benefit and defined contribution plans based on the principle of a prudent person standard. Under ERISA, plan sponsors and other fiduciaries generally must (1) act solely in the interest of the plan participants and beneficiaries; and (2) invest with the care, skill, and diligence of a prudent person with knowledge of such matters; and (3) diversify plan investments to minimize the risk of large losses. Plan fiduciaries that breach any of these fiduciary duties can be held personally liable to repay any losses resulting from the breach, and restore any profits that have been made through use of plan assets. DOL's Employee Benefits Security Administration (EBSA) is responsible for enforcing the fiduciary responsibility provisions of ERISA and issuing related regulations and guidance. As part of its mission, EBSA is also responsible for assisting and educating plan sponsors to help ensure the retirement security of workers and their families.

In the public sector, governments have established retirement plans for their employees at the federal, state, county, and municipal levels, as well as for particular categories of employees, such as teachers. These plans are subject to separate federal or state laws rather than ERISA and investment management is typically overseen by a board of trustees. While public sector plans are not subject to requirements applicable to private sector plans under ERISA, states generally have adopted standards similar to the ERISA prudent person standard.

Few U.S. Retirement Plans Incorporate ESG Factors into Investment Management and Those Doing So Use a Range of Strategies

Few retirement plans in the United States incorporate environmental, social, and governance (ESG) factors into how they manage investments, according to available survey data and our interviews with asset managers. Asset managers we interviewed said retirement plans face several challenges to incorporating ESG factors into their investments including, among others, a lack of consistent and comparable data on relevant ESG factors and regulatory uncertainty. Those retirement plans incorporating ESG factors use a range of strategies including integration, whereby ESG factors are considered alongside other financial data as a core part of investment analysis. Asset managers and state and municipal plans using ESG strategies report enhanced risk management and other benefits.

Few U.S. Retirement Plans Are Reported to Incorporate ESG Factors into Their Investment Management

Available survey data and our discussions with retirement plan asset managers indicate that few defined contribution plans incorporate ESG factors into how they manage their investments. Although there are no nationally representative data on how many retirement plans incorporate ESG factors, two large annual surveys report that few defined contribution retirement plans offer their participants ESG investment options—that is, make options available to participants in which ESG factors have been incorporated into investment management.[24] The Plan Sponsor Council of America's annual survey of about 600 defined contribution plans reports that in 2016 about 2 percent of defined contribution plans offered an ESG investment option as one of the options participants could select from.[25] Additionally, a Vanguard Group report indicates that in 2016 about 8 percent of the 1,900 defined contribution plans served by the firm made available to participants an option where ESG factors had been incorporated into investment management, but where ethical or moral

[24] Other surveys that had smaller sample sizes and/or surveyed endowments, foundations, and retirement plans reported a higher utilization rate of ESG factors. For example, a study commissioned by DOL and issued in December 2017 mentioned a 2015 survey from the Callan Institute, which included over 150 retirement plans, showed that 24 percent of corporate defined contribution plans included ESG investments in their portfolios. For more information on the DOL-commissioned study, which also discusses available online information resources for investors interested in addressing ESG factors, see: Ezeokoli, et al., *Environmental, Social, and Governance (ESG) Investment Tools*.

[25] The Plan Sponsor Council of America is a non-profit trade association supporting employer-sponsored retirement plans. Its members include large and small companies and non-profit organizations, which collectively have more than six million retirement plan participants.

goals may have also been prioritized alongside financial performance—that is, a “socially responsible investment option.”[26] The Vanguard Group report also found that among defined contribution plans that offered a socially responsible fund option, few participants chose to invest in one in 2016. Specifically, out of the total number of participants covered by Vanguard’s data, 18 percent were offered at least one of these options and 3 percent chose to invest in one. Vanguard’s report did not include information to explain why few participants chose to invest in a socially responsible option, including whether the ESG option was offered as a plan’s default option—which, for plans with automatic enrollment, is the investment option a participant would be defaulted into unless they affirmatively select another option. [27]

Defined benefit plans were not included in these surveys, but the asset managers we interviewed who provided information on the topic (5 of 7 asset managers) said that few defined benefit plans in the private sector were incorporating ESG factors into their investment management although some public sector defined benefit plans were.[28] While few retirement plans in the United States incorporate ESG factors, each of the

[26] Vanguard did not use the term ESG in its reporting. According to Vanguard, an investment option was identified as “socially responsible” by the fund provider—either Vanguard or an external fund provider used by plans for which Vanguard acts as record-keeper. As an example of a fund included in this category, Vanguard cited the Vanguard FTSE Social Index Fund, which tracks the FTSE4Good US Select Index. According to documentation from FTSE, this index is designed to measure the performance of companies demonstrating strong ESG practices. For more information on Vanguard’s report, see The Vanguard Group, *How America Saves 2017: A Report on Vanguard 2016 Defined Contribution Plan Data* (June 2017). The Vanguard Group (Vanguard) is a leading U.S.-based investment advisor and provider of mutual funds for retirement plans.

[27] As described later in this report, none of the asset managers we interviewed reported having defined contribution plan clients using ESG factors in their default investment option. To the extent that ESG factors are not included in the plan’s default investment option, participants would have to actively select the ESG fund.

[28] The 2015 survey from the Callan Institute cited in the 2017 study commissioned by DOL reported that 7 percent of corporate (i.e., private sector) defined benefit plans had incorporated ESG factors into their investment management. A more recent 2017 survey from the Callan Institute reported an increase in the incorporation of ESG factors by defined benefit plans compared to 2015. Specifically, the 2017 survey reported that 25 percent of corporate defined benefit plans and 18 percent of corporate defined contribution plans incorporated ESG factors. In addition, the 2017 survey found that 35 percent of public sector plans incorporated ESG factors. The Callan Institute’s survey results were based on a relatively small sample size that included endowments and foundations in addition to retirement plans. Of the 105 survey respondents in 2017, approximately one-third were corporate plans and one-third were public plans.

four large public plans for state and municipal employees we interviewed, which are primarily defined benefit plans, said they are incorporating ESG factors into their investment management to some degree.[29]

In contrast to the large state and municipal defined benefit plans we interviewed, the federal Thrift Savings Plan (TSP), which is a defined contribution plan for federal workers and is the largest public retirement plan in the United States, does not incorporate ESG factors into its investment management, according to officials we interviewed.[30] Specifically, TSP does not incorporate ESG factors into the plan's default option or the other options participants may choose to invest in. As we reported in 2007, these investment options are largely outlined in TSP's authorizing statute.[31] However, the officials told us that an ESG investment option may soon be available to participants. Specifically, the officials said they are planning to implement a "mutual fund window" for TSP beginning in 2020 that will provide plan participants with a wide

[29] In addition to representatives for the four large state and municipal plans we interviewed, a representative from a relatively small, largely defined benefit public sector retirement plan told us that the plan incorporates some ESG factors in its investment decisions. However, the representative told us the plan has not yet developed a formal ESG investment policy.

[30] As prescribed by the Federal Employees' Retirement System Act of 1986, TSP makes available five core funds to plan participants that include a mix of stocks and bonds. Two funds are invested exclusively in bonds—one fund is invested exclusively in short-term U.S. Treasury securities, while the other is invested in a bond index representing the U.S. government, mortgage-backed, corporate, and foreign government sectors of the bond market. Three funds are exclusively invested in stocks—one is invested in a stock index fund made up of a mix of stocks of 500 large to medium-sized U.S. companies, one is invested in a stock index fund made up of stocks of small to medium-sized U.S. companies, and one is invested in a stock index fund made up of stocks of primarily large companies in more than 20 developed nations. Since 2005, TSP participants have had the option to choose one of five life cycle funds, which are target-date funds invested in a mix of the five individual TSP funds, the exact mix determined by a targeted retirement date of the fund participant—the mix of stocks and bonds is adjusted (fewer stocks, more bonds) as the target retirement date draws closer. In a 2012 report, GAO identified challenges TSP faces in adopting a socially responsible investment option which seeks long-term competitive financial returns while realizing positive social impact by investing in accordance with one's values (i.e., an approach that does not primarily focus on the use of ESG factors where they are considered to be material to financial performance). See GAO, *Thrift Savings Plan: Adding a Socially Responsible Index Fund Presents Challenges*, GAO-12-664 (Washington, D.C.: June 26, 2012).

[31] GAO, *Federal Retirement Thrift Investment Board: Many Responsibilities and Investment Policies Set by Congress*, GAO-07-611 (Washington, D.C.: June 21, 2007).

range of investment options outside of TSP's current core funds.[32] The TSP officials told us there is no specific requirement that any of the investment options to be included in the window must address ESG factors, but they expect that such options will be available to plan participants.

Plans Face Data and Other Challenges in Using ESG Factors

Incorporating ESG factors into investment management presents challenges involving data, evidence, costs, and complexity, according to the seven asset managers and four representatives of state and municipal retirement plans we interviewed.

Inconsistent and Incomparable Data

Five of the seven asset managers we interviewed said they had concerns about the quality of data available on ESG factors. Of these, three said that available data on ESG factors are not always consistent or comparable. For example, an asset manager explained that ESG data are not consistently disclosed or reported, whether by publicly listed companies or by ratings agencies, making it difficult to fully assess the impact of ESG factors across the range of assets in their portfolios.[33]

Like the asset managers, the state and municipal plan representatives we interviewed cited concerns about the quality and availability of data on ESG factors relevant to their investments. All mentioned that they had concerns about the availability and quality of disclosures made by companies regarding ESG factors. For example, one plan representative said that in the absence of specific reporting requirements, company disclosures on ESG factors may be incomplete or inaccurate because companies have the discretion to determine what information they provide.[34] One state plan representative said that another challenge to

[32] Congress passed the Federal Retirement Reform Act of 2009, which among other things, authorized TSP to offer a service that would enable participants to invest in mutual funds outside TSP if the Board determined that such a mutual fund window was in the best interests of participants.

[33] In addition to concerns about the availability of consistent and comparable data on ESG factors for individual companies, Securities and Exchange Commission officials reported that the same challenge applies to disclosures provided by ESG funds about a fund's approach for selecting investments. Officials mentioned that such information is often general in nature and does not allow investors to make comparisons across funds.

[34] GAO issued a report on the role of the Securities and Exchange Commission in overseeing climate change-related disclosures by publicly listed companies. See: GAO, *SEC Has Taken Steps to Clarify Disclosure Requirements*, GAO-18-188 (Washington, D.C.: Feb. 20, 2018).

incorporating these factors in its investments is a general lack of standardized data on relevant ESG factors that makes it difficult to draw meaningful comparisons between companies or other potential investments. Another challenge a state plan representative noted is determining which ESG factors are material concerns for a particular company or investment. Specifically, this representative said that some ESG risk factors, like greenhouse gas emissions or demand for water, can generally be quantified for a particular company or investment. However, this representative explained, it is often difficult to associate a cost to such factors when trying to determine whether they represent material investment risks.

Most of the asset managers and state and municipal plan representatives we interviewed said that steps could be taken to address some of the data challenges, such as standardized reporting and disclosures. For example, four asset managers supported ongoing industry efforts to standardize reporting of material ESG factors by companies, particularly the work of the Sustainable Accounting Standards Board (SASB). SASB has developed standards for companies to disclose material information on ESG factors, including a "materiality map" that identifies what it has determined are likely material ESG issues on an industry-by-industry basis.[35] All of the representatives of the four large state and municipal plans we interviewed supported SASB's efforts as well. In addition, most of the state and municipal plan representatives we interviewed mentioned their support for the efforts of the Taskforce on Climate-related Financial Disclosures. This taskforce was established in 2015 by the Financial Stability Board to develop recommendations for standardizing voluntary climate-related financial disclosures that would be useful to actors in the financial sector, such as investors, lenders, and insurance companies.[36]

Concerns with Evidence on Investment Performance

Although the majority of investment scenarios we analyzed showed that incorporating ESG factors has a positive or neutral relationship to financial performance, the perception that incorporating such factors could have a negative impact persists. Four of the seven asset managers we interviewed said some of their clients had concerns about the

[35] SASB's "materiality map" is available at https://www.sasb.org/materiality/sasb-materiality-map/.

[36] The Taskforce on Climate-related Financial Disclosures issued a final report in June 2017 with its recommendations that companies should disclose how they address climate risks in the context of their corporate governance, business strategy, risk management, and approach to measures and performance targets.

sufficiency of evidence on the performance of investments in which ESG factors had been considered. Four asset managers also said some of their clients perceived that it was unclear whether incorporating ESG factors would have a positive effect on investment performance or would justify its costs. For example, one asset manager said some clients believed it was not clear that implementing ESG strategies would achieve sufficient returns when compared to established benchmarks, according to a survey of the firm's clients (which include retirement plans and other institutional investors). However, two of the asset managers said it was a misperception that incorporating ESG factors into investments means sacrificing financial performance, which is consistent with our review of academic research on the subject described previously in this report.

Two asset managers expressed their own concerns rather than those of their clients. One of these asset managers said that using ESG strategies may have an adverse effect on investment performance, particularly negative screening strategies—that is, excluding from investment companies that perform poorly on certain ESG factors. The other asset manager said the empirical evidence on the relationship between ESG investment strategies and investment performance is ambiguous, which helps explain why some retirement plans elect not to incorporate ESG factors into their investment management.

Possibility of Increased Costs and Complexity

Another challenge cited by asset managers is that incorporating ESG factors in investment management may increase costs to retirement plans and their participants. Specifically, four of the asset managers said taking the steps necessary to incorporate ESG factors into investment management may require additional resources and thereby increase costs to plans. Furthermore, one asset manager said that the costs of developing and implementing an ESG strategy may be cost prohibitive for some retirement plans—that is, not every plan can afford to develop the in-house expertise or hire the consultants needed to develop an ESG approach. Similarly, one state plan representative said the cost of incorporating ESG factors is a challenge for smaller retirement plans, which may manage fewer assets and have fewer staff to devote to the issue.

Finally, four asset managers said that incorporating ESG factors increased the complexity of plans for participants, which they said is a concern across the retirement plan industry. Specifically, one asset manager explained that the industry is working to reduce what is sometimes seen as an overwhelming number of investment choices for participants in defined contribution plans. The asset manager added that, for these plans, incorporating ESG factors often means providing an additional fund option. Adding fund options that incorporate ESG factors may therefore add a new level of complexity at a time when the industry's general effort has been to simplify plan offerings.

Uncertainty from Changes in Guidance

Some asset managers cited uncertainty stemming from DOL's changing guidance over time as a challenge. Specifically, three of the asset managers we interviewed said retirement plans found it challenging to rely on DOL's guidance regarding the use of ESG factors, given their view that the guidance had changed significantly with different administrations. In light of these concerns, and other concerns about how the guidance should be interpreted and put into practice, two of the asset managers we interviewed said more education for plans would be helpful—such as examples that plans could follow on how to incorporate ESG factors into their investing.

Those Plans That Incorporate ESG Factors Use a Range of Strategies

Despite the challenges associated with incorporating ESG factors into investment management, some retirement plans are incorporating ESG factors using a range of strategies, according to the asset managers and representatives of the state and municipal plans we interviewed. Of the seven asset managers we interviewed, five reported having retirement plan clients that use strategies to incorporate ESG factors, and representatives of all five state and municipal plans said they were using such strategies.

While some of their retirement plan clients may be using ESG strategies, none of the asset managers we interviewed reported having defined contribution plan clients using them in their default investment option.[37] Instead, the asset managers said some of their defined contribution plan clients offer ESG funds as options that participants may select (in addition to the default investment option or any other fund options that the plan has made available). Three of the asset managers added that although they are not doing so currently, some of their defined contribution clients have expressed interest in incorporating ESG factors into their default options.

[37] Default investment options are used by defined contribution plans for participants who are automatically enrolled and do not select another investment option. Of the four asset managers we interviewed that were able to answer, all said they had no defined contribution plan clients using ESG strategies in their default investment options.

As shown in table 2, strategies used by retirement plans may include considering ESG factors along with other financial data as a core part of investment analysis (i.e., integration). These strategies may also be more explicitly defined, such as limiting investments to those that score well on a certain set of ESG criteria, or excluding those that perform poorly on such criteria (i.e., screening). These strategies could be used by either defined benefit or defined contribution plans. In the case of defined contribution plans, the plan could include investment options that use ESG strategies in the menu of options offered to participants. In the case of defined benefit plans, because funds are invested collectively at the plan level, such strategies can be directly applied to plan assets.

Table 2: Strategies Used by U.S. Retirement Plans to Incorporate Environmental, Social, and Governance (ESG) Factors into Investment Management

Strategy	Definition	Example
Integration	Information on ESG factors is considered along with other financial data as a core part of the investment analysis.	Investment manager considers information on employee health and safety, greenhouse gas emissions, and water and wastewater management, among other information when assessing the valuation, risk, and potential growth for companies in industries where this is material (e.g., oil and gas exploration and production, mining).
Screening	Positive or negative screening to select investments based on established criteria. This strategy may be designed to maintain diversification across industries.	**Positive screening:** Select companies with higher or improving ESG ratings[a] relative to their peers. **Negative screening:** Exclude companies with low ESG ratings relative to their peers, while not excluding a whole industry. Exclude certain industries or products, such as tobacco or controversial weapons.
Engagement	Information on ESG factors is used for activities to monitor or influence the management of companies in which a plan owns stock, such as meeting with corporate boards and filing or voting on shareholder resolutions.	Investment manager meets with board of directors or other representatives to assess how a company is managing material ESG factors. Examples may include the following, among others: • board composition and executive compensation; • policies and practices to address environmental or social factors that have an impact on shareholder value; and • long-term business plans, including plans on climate change preparedness and sustainability.

Source: GAO analysis of documentation from CFA Institute, Department of Labor, Principles for Responsible Investment, and other sources. | GAO-18-398

[a] Several investment research firms have developed ESG ratings or scores to assess a company's exposure to risks and opportunities for ESG factors based on available information.

Integration Is a Common Strategy among Those Private Sector Plans Incorporating ESG Factors

Five of the seven asset managers with private sector retirement plan clients we interviewed reported using an integration strategy to varying degrees, which is a common strategy according to some sources. For example, PRI and CFA Institute's surveys found that integration was the most commonly reported strategy among the institutional investors and service providers they questioned. In practice, investors can take a variety of actions to integrate ESG factors (see text box).

Integration of Environmental, Social, and Governance (ESG) Factors in Practice

According to the United Nations-supported Principles for Responsible Investment (PRI), investors can take a variety of actions to integrate ESG factors into their investment decisions. For example, investors can:

- Adjust how they forecast companies' financial performance or how they value companies for the expected impact of certain ESG factors.
- Construct quantitative models that integrate ESG factors alongside factors such as value, size, momentum, growth, and volatility to guide their investment decisions.
- Use ESG factors and scores as a weight in portfolio construction to reduce risks.

Source: Principles for Responsible Investment, A Practical Guide to ESG Integration for Equity Investing (London, England, United Kingdom: September 2016) I GAO-18-398.

Negative screening to exclude certain industries or products on ESG factors was cited as a strategy by the five asset managers we interviewed with retirement plan clients using ESG strategies. Among the five asset managers with retirement plan clients using ESG strategies, four said they used shareholder engagement. For example, one asset manager told us it engages companies in which it owns stock on corporate governance issues because doing so is a good form of risk management. Another asset manager explained that addressing issues of corporate governance is important to help its clients avoid holding insufficient voting rights for the companies in which they are shareholders. Corporate governance was cited as a key ESG factor by five of the asset managers we interviewed.

Two additional strategies some of the asset managers identified were thematic investing and economically targeted investing. Two asset managers mentioned thematic investing, which focuses on one or multiple ESG factors—as opposed to ESG factors more broadly.[38] In addition, both mentioned economically targeted investments, or sometimes called impact investments, that are made with the intention to generate a financial return alongside measurable social or environmental benefits.[39] These ESG strategies, as well as the more common strategies mentioned earlier, can be used separately or in combination, according to two asset managers.

State and Municipal Defined Benefit Plans Use a Range of Strategies

Despite reported challenges of using ESG factors, each of the five state and municipal plan representatives we interviewed, which all primarily offer defined benefit plans, incorporated ESG factors into their investment management using a range of strategies. Specifically, all of the representatives said they had integrated ESG factors into their investment management, including climate risks (which include risks from the physical impacts of a changing climate on the assets they hold as well as transitional risks stemming from the effects of changes in the economy meant to mitigate or adapt to a changing climate). However, the manner in which they did so varied. For example, a state retirement plan representative said the plan has initiated a 5-year plan to systematically integrate ESG factors into all of its investment management and has developed a set of related investment beliefs. One belief described by the plan representative is that the plan must consider risk factors such as climate change that emerge slowly over long time periods but could have a material impact on its investment returns. This plan has begun pilot programs to put some of these beliefs into practice for the varying classes of assets it holds (e.g., equities, fixed income, and direct real estate holdings). With respect to the potential physical risks of climate change, for example, the plan has a project under way to map the impacts of projected sea-level rises for its real estate holdings. However, representatives of the plan added, there is no readily available source of

[38] For example, thematic funds may include mutual funds focused on investing in renewable energy companies or a fund focused on businesses in sustainable construction (i.e., “green building”). According to the U.S. Green Building Council, green building is generally defined as the planning, design, construction, and operations of buildings while prioritizing, among other things, concerns for energy use, water use, indoor environmental quality, and a building’s effects on its surroundings.

[39] An impact investment fund may be focused on issues such as affordable housing and community development.

data to assess these risks. Representatives for another state plan said they had integrated ESG factors, including climate risks, by developing a list of risk factors to be considered by all of its asset managers before making any investment decision. For example, according to the list of risk factors, an asset manager must assess how an investment's business activities and exposure to certain environmental risk factors, including climate change, are expected to affect long-term profitability. The representatives explained that the plan's asset managers have discretion to assess the relevance of the risk factors on a case-by-case basis and that the plan has not established specific criteria that the asset managers are required to apply. Representatives from this plan also told us they were taking steps to assess the portfolio's risks under a range of future climate-change scenarios.

In addition to integration, all of the state and municipal plan representatives we spoke with said they relied on shareholder engagement as an important strategy for addressing their concerns about ESG factors such as climate risks. For example, to address the transitional risks associated with climate change, a state plan representative told us their plan had identified the companies that are responsible for the majority of greenhouse gas emissions in its portfolio, and is engaging those companies to encourage them to take the steps necessary to lower their emissions—thereby reducing its exposure to the potentially disruptive effects of a transition to a low-carbon economy (such as a tax on carbon emissions).

Those Using ESG Strategies Report Enhanced Risk Management and Other Benefits

When asked what benefits, if any, incorporating ESG factors into investment management offered to retirement plans, all seven asset managers we interviewed offered examples of benefits, including enhanced risk management, improved long-term outcomes, and increased participation.

- **Enhanced risk management.** Six of the asset managers said that incorporating ESG factors enhanced retirement plans' risk management. For example, an asset manager explained that assessing a company on how it addresses ESG risk factors can give investors a better idea of the quality of the company's management, thereby enhancing how the investor manages risks. Another asset manager said its clients viewed incorporating ESG factors as a means to help manage the volatility of their portfolios.

- **Improved long-term performance.** Four of the asset managers we interviewed said they expect incorporating ESG factors to improve the long-term performance of retirement plan portfolios. For example, one asset manager explained that ESG factors provide investors with additional information that goes beyond what is assessed in traditional financial analysis, and this provides a more complete picture of potential investments, and potentially enhances long-term investment outcomes. In addition, two other asset managers explained that they believe companies that have effective ESG practices are better managed in the long run and therefore are better performers financially.
- **Increased participation.** Four of the asset managers said that incorporating ESG factors helped retirement plans meet participant preferences for ESG-type investment options. The asset managers said that incorporating ESG factors can help plans meet participant preferences and increase participation rates. Specifically, an asset manager said that having ESG investment options within a retirement plan may make certain demographic segments, particularly younger investors, more enthusiastic about investing, thereby increasing their participation in the retirement plan.

Each of the representatives for the four large state and municipal plans we interviewed cited similar benefits of incorporating ESG into their investment management and said that addressing ESG factors is a form of effective risk management. For example, one plan representative told us that poor ESG practices can decrease the value of a company, thereby harming shareholders' investments in the company. To protect its investments against such poor practices, this retirement plan has engaged companies in which it is a shareholder and has sought reforms on a range of issues, including aligning executive pay with long-term performance and promoting sustainability in supply chains. In addition, representatives of each state and local plan we interviewed said that incorporating ESG into investment management enhances the long-term returns of their investment portfolios. Two plan representatives said that research shows that companies that score well on ESG factors tend to have better financial performance in the long term.

Plans in Other Countries Reported Using Strategies to Systematically Incorporate ESG Factors and Providing Public Disclosures

The plans we reviewed in France, the Netherlands, and the United Kingdom reported using strategies, such as screening and integration, to systematically incorporate ESG factors across their portfolios. In implementing their ESG strategies, plan representatives described taking similar steps, such as including ESG factors in the plan's stated investment policy, soliciting and monitoring information on the use of ESG factors from external asset managers, and communicating information to participants. Representatives from these plans also described targeted efforts to address climate risk in particular, including tracking the plan's exposure to carbon emissions and setting targets for reducing the amount of emissions attributed to their portfolio.[40] In addition, plan representatives and government officials said the disclosure requirements the plans are subject to encourage plans to address ESG risks and provide transparency.[41]

Selected Plans in Other Countries Used Various Strategies to Systematically Incorporate ESG Factors

Representatives from the retirement plans we reviewed in France, the Netherlands, and the United Kingdom reported using strategies, such as screening and integration, to systematically incorporate ESG factors into their investment management. Two of these retirement plans—in France and the Netherlands—are for public sector employees and one plan—in the United Kingdom—is for private sector employees. While the details of each strategy varied, plan representatives reported that information on ESG factors was used systematically, with each plan establishing ESG criteria to manage investment risk and applying these criteria across the multiple asset classes included in the plan's portfolio as described below.

France's Régime de Retraite Additionnelle de la Fonction Publique (RAFP)

According to representatives from RAFP—a hybrid defined benefit plan that provides supplemental retirement benefits for public sector employees—the plan works with its external asset managers to use a "best-in-class" screening strategy for ESG factors.[42] As described in RAFP's 2016 annual report, the best-in-class strategy consists of

[40] For additional information on each plan and their ESG strategy, see appendix II.

[41] We did not conduct an independent legal analysis to verify the information provided about the laws, regulations, or policies of the countries selected for this objective. Instead, we relied on appropriate secondary sources, interviews, and other sources to support our work.

[42] As described earlier, a hybrid defined benefit plan generally allows adjustments to both contributions and benefits depending on the plan's funding level. Upon retirement, the plan typically provides monthly income to participants.

quantitative rules based on ESG scores to determine which assets are eligible for investment while not excluding any sector from investment. To implement this strategy, representatives from RAFP said that potential investments for an asset class, such as equities, are subject to a two-stage screening process. As part of this process, the asset manager assesses a potential investment's ESG rating for specific ESG factors, as well as their overall ESG score relative to similar investments. In the case of equities, the plan's asset manager rates companies on key ESG factors specified in the plan's investment policy, such as management of environmental risks, and those that have ESG scores in the bottom half of their sector (for at least one of the key ESG factors) are excluded. Second, companies are reviewed based on their overall ESG score and those in the lowest quartile for their sector are excluded. According to a plan representative, companies that are determined to have met both of these screens are considered to be eligible for investment and the plan's external asset managers use additional factors to make investment decisions. Representatives from RAFP said that the application of the best-in-class strategy generally follows these rules, but it may vary by asset class.

The Netherlands' Stichting Pensioenfonds ABP (ABP)

The asset manager for ABP—a hybrid defined benefit plan for public school and other government employees—said the plan developed an "inclusion" strategy to incorporate ESG factors when selecting equities and bonds for investment.[43] Under this strategy, ABP's asset manager said that companies and issuers are analyzed based on ESG factors that were determined to be material. For example, according to ABP's 2016 annual investment report, ESG factors such as environmental pollution and workplace safety have been identified as material risks in the oil and gas sector whereas corporate ethics, such as involvement in bribery and corruption, money-laundering, and the credibility of a whistle-blower process are material risks in the financial sector.[44] ABP's asset manager said they use information on material ESG factors from ESG research firms as well as information gained through direct engagement with companies and internal research. ABP assesses how these material ESG factors are managed and categorizes the companies and issuers as either "leaders" or "laggards." The plan invests only in equities or bonds of

[43] Algemene Pensioen Groep (APG) is the asset management and administrative entity for Stichting Pensioenfonds ABP (ABP) and spoke on behalf of the plan for our interview. According to ABP's 2016 investment report, ABP owns 92 percent of the shares in APG.

[44] Stichting Pensionenfonds ABP, *Sustainable and Responsible Investment 2016* (June 2017).

companies and issuers classified as leaders and a subgroup of those classified as laggards, which it considers having the potential to improve. According to ABP's 2016 investment report, the plan aims to have fully implemented their inclusion strategy for equities and bonds by 2020.[45] In addition to equities and bonds, this report states that the inclusion strategy is also applied to alternative asset classes, such as real estate, infrastructure, and private equity.

United Kingdom's National Employment Savings Trust (NEST)

Representatives from NEST—a defined contribution plan established by the national government to help private sector employers meet their obligation to automatically enroll eligible employees in a retirement plan—said that the plan works with its external asset managers to use an integration strategy to incorporate ESG factors into investment decisions. Specifically, plan representatives said that ESG factors are fully integrated into the plan's default investment option, which covers nearly all participants (99.8 percent) and includes multiple asset classes. A representative from NEST shared the view that incorporating ESG factors into the plan's default option was important because it helps enhance risk-adjusted returns and it is a central part of the plan's risk management. If ESG risks were not addressed in the plan's default option, the representative said that such risks would not be effectively addressed because so few participants select an option outside of the default option. Representatives from NEST and their asset managers described examples of how NEST incorporates ESG factors within the default option. For example, for an equities fund that is part of the default option, representatives from NEST and one of their asset managers said that the fund is benchmarked to a broad stock market index and ESG factors are used to overweight (i.e., increase) the amount invested in some companies and underweight (i.e., reduce) the amount invested in others rather than screening out companies or sectors. NEST's representatives also said that ESG factors are used in an emerging markets equity fund because risks related to ESG factors are particularly important in these markets. In addition, one of NEST's asset managers said that the plan uses ESG factors to select and monitor investments in United Kingdom (UK) real estate. According to NEST's 2017 annual report, the plan is in the process of incorporating ESG factors into other asset classes, such as commodities and infrastructure.[46]

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[45] Stichting Pensionenfonds ABP (2017).

[46] National Employment Savings Trust, *Delivering Change 2017 Report: An Update on Our Responsible Investment Activities This Year* (2017).

Other Aspects of Selected Plans' Use of ESG Factors

In conjunction with these investment strategies, each of the plans we reviewed in other countries reported using ESG factors in engagement activities, such as meeting with corporate boards and voting on shareholder resolutions. They also cited benefits and challenges associated with their efforts to incorporate ESG factors in investment management.

Engagement

Representatives from each plan or their asset manager said they focus on engaging with companies identified as having ESG risks that are not sufficiently well-managed. Representatives from the plan we reviewed in France and the asset manager for the plan we reviewed in the Netherlands said that the plans consider this type of engagement to generally be a more effective strategy than divesting from such companies. In 2016, the Netherlands' ABP reported engagement with 245 companies on ESG factors, mostly related to governance. Representatives from the plans in France and the United Kingdom said their plans coordinate with external asset managers to engage with companies on ESG factors. To do this, representatives from both plans said they provide engagement guidelines, including on ESG factors, to their external asset managers and regularly monitor how asset managers are voting the plan's shares in accordance with guidelines. Representatives from France's RAFP said that coordinating engagement activities can be a challenge because the plan uses multiple external asset managers. They said that each year the plan reviews how their asset managers voted on the same shareholder resolutions for certain companies and could identify differences. Representatives from the UK's NEST also described coordinating with an external manager to obtain information on planned votes for upcoming shareholder resolutions. NEST considers how the asset manager intends to vote and, if the plan determines that ESG factors need to be addressed, the representatives engage with the asset manager, and in certain cases override the external manager's planned vote.

Benefits and Challenges

Representatives of the three plans we reviewed in the other countries cited risk management and improved long term financial performance for the plan as reasons for incorporating ESG factors into their investment decisions. According to ABP's asset manager, the plan includes information on ESG factors because doing so provides a more comprehensive view of the long-term risks and opportunities of an investment. In addition, representatives from NEST said that considering material ESG factors is necessary for understanding investment risk and the long-term sustainability of a company. A representative from RAFP also said that ESG factors help the plan maximize long-term, sustainable returns. Similarly, documentation from RAFP states that the use of ESG factors is intended to better assess medium- and long-term risks and identify companies that are well-positioned for long-term growth. In addition to these benefits, representatives from RAFP and ABP's asset manager also said that addressing ESG factors helps to manage reputational risks for the plan with its participants. ABP's asset manager said that participant engagement has shown that participants have a significant interest in managing ESG factors. Similarly, RAFP's representative said that participants scrutinize the plan's investment holdings in the event of a scandal related to ESG factors at a company the plan may invest in.

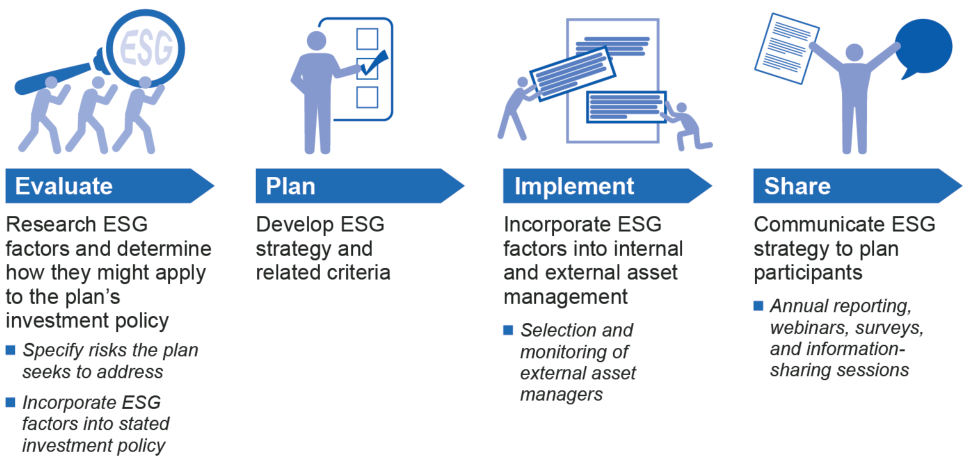
The plan representatives and asset managers we interviewed in the three countries also cited challenges in incorporating ESG factors similar to those cited by U.S. asset managers and plan representatives, such as ESG data quality. For example, one asset manager for NEST said that ESG data are inconsistently reported, which makes it difficult to interpret. Despite its limitations, this asset manager said ESG data are still useful and they use multiple ESG data sources for comparison in their investment analysis. Likewise, ABP's asset manager said that data quality is the primary challenge to implementing an ESG strategy, but it is not insurmountable. The asset manager said that they assess available data to understand how it was collected and how it can be appropriately used. To improve data quality, ABP's asset manager said that the plan supports efforts to standardize reporting on ESG factors, such as those by the Task Force on Climate-related Financial Disclosures and the Sustainable Accounting Standards Board. In addition to data quality, an RAFP representative said that a lack of knowledge on ESG issues and an over-emphasis on short-term returns is a challenge for using ESG factors, which are focused on long-term sustainable returns.

Selected Plans Take Similar Steps to Incorporate ESG Factors

While the details of each plans' ESG strategy varied, plan representatives described similar steps to implement their strategies. As shown in figure 4, an initial step is for the plan to consider incorporating ESG factors into the plan's investment policy. For example, representatives from NEST said that the plan engaged in a 2-year consultation period to develop its investment policy and strategy, which included considering the use of ESG factors. Following this consultation period, NEST published the plan's Statement of Investment Principles, which states that the plan integrates ESG factors to address long term risks, such as climate change. Similar to NEST, representatives from ABP's asset manager and

RAFP said that ESG factors were included in their plans' investment policy statements. In addition, the plan representatives said they took steps to develop their ESG strategy and related criteria, such as the best-in-class strategy and investment rules used by RAFP.

Figure 4: Steps Taken by Selected Retirement Plans in France, the Netherlands, and the UK to Incorporate Environmental, Social, and Governance (ESG) Factors into Investment Decisions



Source: GAO analysis of plan documentation and interviews with representatives from France's Régime de Retraite Additionnelle de la Fonction Publique, the Netherlands' Stichting Pensioenfonds ABP, and the U.K.'s National Employment Savings Trust. | GAO-18-398

Once a strategy is established, plan representatives described steps to implement it. For example, representatives from RAFP and NEST said they ask questions about an asset manager's use of ESG factors and related processes in requests for proposals, which are used to hire asset managers. (See textbox.) Representatives from RAFP and NEST said they also monitor the use of ESG factors in their asset managers' engagement activities, such as proxy voting, as described earlier.

Examples of Environmental, Social, and Governance (ESG)-related questions included in requests for proposals to hire asset managers

Questions:

- Detail the extent to which ESG risks and opportunities identified are factored into your investment process, and how this is done. Describe their relevance from a risk/return perspective to the proposed strategy.
- Provide two examples of when ESG issues have influenced your investment decisions.
- Detail to what extent ESG risks are monitored as part of your overall risk management function.
- Describe the data sources (either proprietary or external) used to help identify ESG risks in your portfolio. Your response should include how these are prioritized and addressed.
- Attach your ESG/Sustainability policy for (specified asset class) if available.
- Do you have a dedicated ESG research team? If yes, could you describe the team (size, skills/expertise, average experience)?
- Have you developed some key performance indicators to measure environmental (for instance, carbon footprint) and/or social (for instance, growth of the employment) impacts of your investments? If yes, describe the indicators used, the number of portfolios included and assets covered by this type of reporting.

Source: Documentation provided by the UK's National Employment Savings Trust and France's Régime de Retraite Additionnelle de la Fonction Publique. | GAO-18-398

After implementing their ESG strategy, an additional step for plans is to communicate it to participants. For example, according to ABP's asset manager and plan documentation, the plan has taken multiple steps to communicate its ESG strategy to participants, including conducting a series of stakeholder meetings with plan representatives and participants, webinars on using ESG factors and investment returns, a participant survey, and annual reporting.

Climate Risk Is Addressed Through Targeted Strategies

As an example of how ESG factors are used, representatives from each plan we reviewed in the other countries reported using a targeted strategy to address climate risk, including tracking the plan's exposure to carbon emissions and setting goals for reducing the amount of emissions attributed to their portfolio.

France's RAFP

RAFP's representatives said that they consider climate change to be a key ESG factor and described using a targeted strategy to address climate risks. Specifically, plan representatives said that they have incorporated climate risks into their investment strategy through their best-in-class strategy and by tracking the plan's exposure to carbon emissions. According to one plan representative, retirement plans such as RAFP are particularly focused on climate risk because of their long time horizon. As a first step, plan representatives said they assessed the carbon footprint of their equity portfolio and found it to be lower than the relevant benchmark. To further reduce their portfolio's carbon footprint, RAFP representatives said they have invested in low-carbon index funds. According to the plan's 2016 annual report, the carbon footprint for its equity portfolio was 17 percent lower than the benchmark. The plan also tracks the carbon footprint for investments in bonds and together with their equity portfolio, a total of 89 percent of the plan's assets are included in their carbon footprint. The report states that the carbon footprint measures the plan's exposure to transition risk from climate change (i.e., effects of changes in the economy meant to mitigate or adapt to a changing climate). The plan reports that it seeks to have a lower carbon footprint relative to its benchmark because it means that the companies they are invested in will, on average, be better placed to address challenges related to changes in energy sources (e.g., transitioning from fossil fuel-intensive sources to renewable energy sources). Plan representatives said that they balance their goal of reducing the portfolio's carbon footprint with maintaining diversification across sectors. For example, they said the plan remains invested in the oil and gas sector and seeks to invest in the companies within that sector that it considers to be best positioned to address long-term risks from climate change.

Regarding physical risks from climate change, an RAFP representative said that their plan's investment strategy is still in development. The representative said that French law requires retirement plans to address both transitional risks and physical risks from climate change, but that this requirement is relatively new and the science and data on physical risk are still being developed. The plan is in the process of reviewing its portfolio to assess the plan's exposure to these risks, including its real estate holdings.

The Netherlands' ABP

ABP's asset manager said that considering risks and opportunities related to climate change is integral to the plan's investment-decision making process. As described in the plan's 2016 annual investment report, the plan has established carbon emission reduction targets to address investment risks the plan faces from measures governments will or could take as part of their climate policies, such as taxing carbon emissions. Specifically, the plan has established a target for reducing the carbon footprint of its investment portfolio by 25 percent by 2020 compared to 2014 levels. The asset manager said that this effort is initially focused on equity holdings, but will eventually be extended to all asset classes held by the plan. To meet this commitment, ABP's asset manager said that they use data from an external provider to identify carbon budgets for each sector and factor this into their investment decision-making. For companies the plan has invested in, this information is used in conducting engagement to encourage efforts to reduce a company's carbon footprint. By the end of 2016, the plan reported that it had reduced carbon emissions by 16 percent compared to 2014. In addition to the emission reduction targets, the 2016 annual investment report notes that the plan increased investments in renewable energy and green bonds.

United Kingdom's NEST

Representatives from NEST and the plan's asset managers also described targeted strategies to address climate related risks and opportunities. In particular, representatives from NEST cited the plan's "Climate Aware" fund which is included in the default investment option. According to the representatives, the purpose of this fund is to increase the default option's exposure to companies that are positioned to do well in a low-carbon economy. Plan representatives said that this fund is designed to deliver investment returns that are similar to a broad stock market index, while adjusting the weight of investments in companies based on its rating for ESG factors related to climate risks. For example, some of these factors include assessing whether companies are on track to meet established emission reduction targets, the amount of a company's fossil fuel reserves, and whether they use or produce energy from renewable sources. According to plan representatives, the fund will increase the amount invested in companies that rate favorably on such criteria while reducing the amount invested—rather than divesting completely—in companies that rate poorly. Representatives from the asset manager for this fund said that it considers the current carbon footprint of companies and their estimated trajectory for future emissions, as well as evidence that the company's management is committed to emission reductions. Plan representatives said they will monitor the fund's performance and consider adjusting the weighting and other criteria used within the fund depending on performance.

In addition to the Climate Aware fund, representatives from one of NEST's asset managers said that climate risk is included in the ESG risk assessment for the plan's real estate fund, which is part of the default investment option. According to the asset manager, in managing assets on behalf of NEST, they conduct an environmental risk assessment for potential investments that includes an assessment of physical risks of climate change, particularly flood mapping. Documentation from the asset manager also shows that the asset manager has established a goal of reducing energy and water consumption and carbon emissions by 20 percent for UK property holdings compared to 2010 levels. Going forward, representatives from NEST also said that they are planning to incorporate more ESG data on climate risk, particularly data on rising sea levels, into their investment decisions.

Plan Representatives and Agency Officials in Selected Countries Reported That Governmental Policies May Encourage Plans to Address ESG Risks

According to retirement plan representatives and government officials, plans we reviewed in France, the Netherlands, and the United Kingdom are subject to disclosure rules and requirements on their use of ESG factors as described below.[47] Plan representatives and agency officials noted that these disclosures may encourage plans to address ESG risks.

- **France's RAFP.** RAFP representatives said that the plan provides disclosures, which they said are required by law, on its use of ESG factors, including climate risks. An official from the French Ministry for the Economy and Finance—the agency that oversees disclosures of retirement plans' use of ESG factors—said that institutional investors, such as retirement plans, with more than €500 million in assets are required to disclose how ESG factors are considered in their investment decisions or explain why they are unable to do so. As part of this requirement, the official said that plans are required to disclose their exposure to climate risks. The government official said that, prior to current requirements that were established in 2015, asset managers often had been reporting on their use of ESG factors in a generic way that did not indicate serious consideration of such risks. In comparison to earlier disclosure requirements, the official said that current requirements ask for more detailed information, particularly for environmental factors such as climate risk.
- **The Netherlands' ABP.** ABP's asset manager said that the plan is required to disclose whether or not ESG factors are taken into

[47] For more information on each plan's disclosures of their investment policy and use of ESG factors, see appendix II.

account in its investment decisions. According to an official from the Dutch National Bank (DNB), DNB oversees retirement plans in the Netherlands and plans have been required since 2015 to disclose in their annual report how they incorporate ESG factors. The official said that, under the current rule, plans are not required to incorporate ESG factors, but the plan must explicitly disclose if it does not do so in its written investment policy. The official said that DNB conducted a survey in 2015 and found that the vast majority of retirement plans had at least some mention of a policy related to ESG factors in their annual report. The official also said that, starting in 2019, new rules are expected to go into effect that require retirement plans to incorporate ESG factors and describe their approach to such risks in their investment policy. As part of this new requirement, the official said that plans will be expected to conduct some stress testing of their portfolios for climate-related risks.

The United Kingdom's Pensions Regulator's Guidance on Climate Risk

The Pensions Regulator's guidance for defined benefit retirement plans to develop and disclose its investment policy provides examples of how a plan may address climate risk. Specifically, the guidance states that plan trustees may establish the following investment principle:

"As long-term investors, we believe climate risk has the potential to significantly affect the value of our investments."

The guidance also provides the following examples of how plans may disclose this investment belief in the plan's investment policy:

- "We expect fund managers to have integrated climate risk into their risk analysis and investment process."
- "We will try to ensure that we manage all new and existing investment arrangements in a way that takes account of climate risk."
- "In monitoring the performance of our fund managers, we will also regularly consider how they are performing with reference to climate risk issues."

Source: The Pensions Regulator, Investment Guidance for Defined Benefit Pension Schemes (March 2017) I GAO-18-398.

Plan representatives, government officials, and stakeholders we spoke with cited several goals of the disclosure requirements, including encouraging plans to address ESG risks and providing transparency. For example, an official from the French Ministry of the Economy and Finance said that the government introduced disclosure requirements in order to encourage plans to consider ESG factors because they consider ESG risks to be material and significant. The official said that requirements for plans and other investors to consider ESG risks and disclose how they do so has caused plans to be more systematic in assessing ESG factors across asset classes. Similarly ABP's asset manager said that the disclosure requirement helps ensure ESG risks are managed by plans. Representatives from a stakeholder organization in the UK said that

[48] The Pensions Regulator, *Code of Practice No. 13: Governance and Administration of Occupational Trust-Based Schemes Providing Money Purchase Benefits* (July 2016).

[49] The Pensions Regulator, *Guide to Investment Governance: To Be Read Alongside Our DC Code of Practice No. 13* (July 2016).

without disclosure requirements, it is easier for plans to disregard ESG risks. In addition to encouraging plans to address ESG risks, representatives from a French association of asset managers said that the disclosure requirements are intended to provide transparency about different strategies for addressing ESG risks, such as climate change, rather than to endorse a particular strategy. Similarly, the official from the French Ministry of the Economy and Finance said that strategies to address climate risks are still evolving and the disclosure requirements could foster information-sharing on methods to address such risks.

DOL Has Provided Limited Information on How Retirement Plans May Incorporate ESG Factors

In the United States, DOL's guidance explains that private sector retirement plans may incorporate material ESG factors in investment analysis and that ESG factors are appropriate issues for shareholder engagement; however, it does not address some of the issues plans face when considering use of ESG factors. In particular, DOL has not addressed the issue of whether a defined contribution plan may incorporate ESG factors in the plan's default option and qualify for certain legal protections. DOL is also considering changes which, if adopted, could result in the collection and public disclosure of some information on the use of ESG factors by private sector retirement plans, which are subject to provisions of the Employee Retirement Income Security Act of 1974 (ERISA).

DOL's Guidance Explains That Retirement Plans May Incorporate ESG Factors in Investment Management

DOL's 2015 and 2016 interpretive bulletins—which provide guidance to U.S. private sector retirement plans—identify material ESG factors as proper components of a retirement plan's investment analysis and appropriate issues for shareholder engagement activities.[50] The bulletins state that incorporating ESG factors can be consistent with ERISA fiduciary responsibilities and emphasizes that fiduciaries are responsible

[50] DOL's 2015 interpretive bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments sets forth supplemental views of DOL concerning the interpretation of sections 403 and 404 of Part 4 of Title 1 of ERISA as applied to employee benefit plan investments in economically targeted investments. According to its preamble, the guidance in the interpretive bulletin also applies to ESG investing.

DOL's 2016 interpretive bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies or guidelines sets forth DOL's interpretation of sections 402, 403, and 404 of Part 4 of Title 1 of ERISA with respect to voting of proxies, statements of investment policy, and exercise of other legal rights of a shareholder.

for considering factors that potentially influence risk and return, which can include material ESG factors.[51] The bulletins state DOL's stance that fiduciaries may not accept lower expected returns in pursuit of collateral benefits, which are benefits outside of investment returns. The preamble to the 2015 bulletin further explains that ESG factors can have a direct relationship to the economic value of a plan and in such a case the ESG factors are not collateral but are considered as part of the primary analysis of an investment, and the use of material ESG factors should not inherently be subject to special scrutiny. The 2016 bulletin goes on to clarify that ESG factors can be appropriate topics for proxy voting policies and engagement with corporations. Both the preamble to the 2015 bulletin and the 2016 bulletin refer to the use of ESG factors by retirement plans generally and do not distinguish between how such factors may be used by defined benefit and defined contribution plans.[52]

The 2015 and 2016 bulletins updated and replaced two interpretive bulletins issued in 2008 that encompassed the use of ESG factors, but did not address the potential for a direct relationship to the economic value of a plan's investments. Similar to the 2015 and 2016 bulletins, the 2008 bulletins stated that fiduciaries may not subordinate the economic interest of plan participants in pursuit of collateral economic or social benefits, which are understood as inclusive of ESG.[53] However, they did not discuss the potential for ESG factors to affect the risk or return of an investment. Unlike the updated bulletins, the first interpretive bulletin from 2008 also stated that using such strategies should be rare, and that to demonstrate compliance with ERISA, fiduciaries would need a documented economic analysis to provide evidence that using ESG factors was not expected to harm returns.

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[51] ERISA requires fiduciaries to act prudently and solely in the interest of plan participants and beneficiaries. See 29 U.S.C. § 1104(a).

[52] After our audit work was completed and while our report was being reviewed by DOL, it issued new guidance on the use of ESG factors in Field Assistance Bulletin No. 2018-01. For a discussion of the field assistance bulletin and our response to DOL's comments, see the Agency Comments and Our Evaluation section of this report.

[53] Likewise, DOL issued an Advisory Opinion in 1998 regarding the inclusion of a "socially-responsible fund" in a defined contribution plan. In the opinion, DOL stated that fiduciary standards do not preclude the consideration and selection of an investment option with collateral benefits if the fiduciary has determined that offering such collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks. See DOL Advisory Opinion 1998-04A, May 28, 1998.

When issuing the updated bulletins in 2015 and 2016, DOL stated that the 2008 versions may have unduly discouraged the use of ESG factors and resulted in a chilling effect on the uptake of strategies to incorporate ESG factors. This concern was also raised by several industry stakeholders we interviewed. The preamble to the 2016 bulletin also identified concerns that the 2008 bulletins were not aligned with important domestic and international trends in investment management. Among these trends DOL specifically cited the growing number of institutional investors engaging companies on ESG issues and the growing recognition that these issues may have an impact on the long-term value of an investment. Still, DOL officials stated that since issuing the 2015 and 2016 bulletins they have not received questions from fiduciaries. Several of the asset managers we interviewed said that the bulletins were helpful as they clarified that ESG factors can be an appropriate consideration for retirement plans. However, given that there have been several changes to the bulletins, some asset managers said that there is uncertainty about the potential for further changes that could impact their ability to consider ESG factors.

DOL's Guidance Does Not Address Uncertainties Plans Face in Incorporating ESG Factors

While DOL has issued broad guidance that explains that plans may consider using ESG factors in their investment management, the agency has not specifically addressed whether protection from potential litigation for defined contribution plans extends to default investment options that incorporate ESG factors. Fiduciaries for defined contribution plans face uncertainty because DOL's ESG guidance generally recognizes that ESG factors may be appropriate considerations without distinction by plan or fund type; yet it is unclear whether using such factors would be permissible in Qualified Default Investment Alternatives (QDIA), which are widely used by defined contribution plans to automatically place participants in a default investment option if participants do not actively select another option. In addition, DOL has not provided information to assist fiduciaries for defined benefit or defined contribution plans in investment management involving ESG factors which may help address uncertainty and the need for education on ESG issues cited by some asset managers we interviewed.

Qualified Default Investment Alternatives (QDIA) and Additional Information

DOL's QDIA regulations identify types of investment options in which defined contribution plan sponsors can automatically enroll participants in a defined contribution plan and receive "safe harbor" protection from potential litigation. Specifically, in 2007, DOL issued final regulations outlining conditions under which a plan fiduciary would generally not be liable for any investment losses that occur as a result of investing contributions on behalf of participants and beneficiaries.[54] Examples of these types of investment options include target date funds, balanced funds, and managed accounts.[55] Industry data from Vanguard shows that many defined contribution plans use a QDIA. Specifically, Vanguard reports that 80 percent of plans designated a QDIA at the end of 2016 and over 90 percent of designated QDIAs were target date funds.[56]

Although many defined contribution plans designate a QDIA, DOL's QDIA regulations and ESG interpretive bulletins do not specifically address the potential use of ESG factors in a QDIA and agency officials said it is unclear whether using such factors would comply with regulations. As previously described, most asset managers we interviewed identified ESG factors as a valid risk mitigation strategy and some asset managers said they have had discussions with clients who have expressed interest in incorporating ESG factors within a default option. More broadly, all of the asset managers and state and municipal plan representatives we interviewed said that incorporating ESG factors in investment management offered benefits to plan participants. However, DOL officials told us that they have not considered whether the use of ESG factors in a default option's investment strategy impacts its ability to comply with existing QDIA regulations. They added that fiduciaries may be hesitant to adopt such a product as a default option absent specific guidance due to potential litigation risk. As we reported in 2015, plan sponsors and stakeholders have previously stated concerns that any change to a QDIA could expose sponsors to additional fiduciary liability.[57] Moreover,

[54] This fiduciary relief is also referred to as "safe harbor" protection. See Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452 (Oct. 24, 2007) (codified at 29 C.F.R. § 2550.404c-5).

[55] We found that at least one target date fund offered by an asset manager that incorporates ESG factors. A target date fund or life cycle fund is an investment product or model portfolio that is designed to become more conservative as the participant's age increases, a balanced fund is an investment product or model portfolio that is designed with a mix of equity and fixed income exposures appropriate for the participants of the plan as a whole, and a managed account is an investment management service that uses investment alternatives available in the plan and is designed to become more conservative as the participant's age increases.

[56] See Vanguard, *How America Saves 2017: Vanguard 2016 Defined Contribution Plan Data* (Valley Forge, Pa.: June 2017). This report is based on non-generalizable data from the 1,900 defined contribution plans for which Vanguard serves as record keeper.

[57] For example, as described in this report, one plan sponsor stated that fear of potential litigation kept it from changing a QDIA even though participants would be better served by the change. GAO, *401(k) Plans: Clearer Regulations Could Help Plan Sponsors Choose Investments for Participants*, GAO-15-578 (Washington, D.C.: Aug. 25, 2015).

because the 2015 and 2016 guidance refers to plan investments generally, it may not be clear to fiduciaries that DOL could view the use of ESG factors in a QDIA differently than in other investment options.

The mission of DOL's Employee Benefits Security Administration includes educating fiduciaries to ensure they are equipped to fulfill their duty to act prudently and in the best interest of participants, which includes understanding the potential risks and returns of an investment. As described in *Standards for Internal Control in the Federal Government*, the agency should externally communicate the necessary quality information to achieve the entity's objectives.[58] Without clarification, fiduciaries for defined contribution plans face uncertainty as to whether they are permitted to incorporate ESG factors in their QDIA. As a result, the fear of potential litigation may dissuade them from considering information that DOL has acknowledged may directly impact the plan's financial performance. Further, if DOL determines that the use of ESG factors is not consistent with the QDIA regulations, such a conclusion would be an important clarification to assure that fiduciaries do not inadvertently violate them.

In addition to the lack of clarity regarding QDIAs, DOL has not provided additional information to help fiduciaries for defined benefit or defined contribution plans in investment management involving ESG factors more broadly, including how to identify and evaluate options not limited to a QDIA. As described previously, the use of ESG factors is an emerging practice and retirement plans face challenges related to data quality and complexity, among other issues. In other cases where plans may face complexity, such as when a fiduciary selects a target date fund or monitors pension consultants, DOL has provided general information,

[58] GAO, *Standards for Internal Control in the Federal Government,* GAO-14-704G (Washington, D.C.: Sept. 10, 2014).

including items to consider and questions to ask.[59] These types of materials, for example, could help fiduciaries identify practical steps to take when considering potential investment strategies. DOL officials told us that they have received no questions about the 2015 and 2016 guidance; however, each asset manager and plan we interviewed cited challenges incorporating ESG factors, such as the complexity and varying quality of information. As previously stated, the mission of DOL's Employee Benefits Security Administration includes educating fiduciaries to ensure they are equipped to fulfill their duty to act prudently and in the best interest of participants. In the absence of additional information, fiduciaries may have difficulty determining appropriate issues to consider in investment management involving ESG factors. Fiduciaries that decide to pursue using ESG factors may face difficulty identifying and evaluating available options. Lastly, without additional information plans may be reluctant to pursue ESG strategies because they do not understand risks that could be considered material and they may not be able to effectively select and monitor an ESG strategy.

DOL Is Considering Steps to Collect Data on ESG Use among Retirement Plans

DOL officials stated that while there is currently no mechanism for the agency to collect information on ERISA retirement plans' use of ESG factors, changes to the Form 5500 are being considered that could capture this type of information.[60] The proposed changes to the Form 5500 cover a range of topics, and the section specific to ESG includes a

[59] DOL's *Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries* provides fiduciaries with a list of items to remember when choosing a target date fund. For example, the items include "[e]stablish a process for comparing and selecting target date funds" and "[r]eview the fund's fees and investment expenses." In addition, the document also provides fiduciaries with a list of other related resources to consult. See DOL, EBSA, *Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries* (Washington, D.C.: February 2013).

DOL's *Selecting and Monitoring Pension Consultants – Tips for Plan Fiduciaries* provides fiduciaries with a set of questions to ask pension consultants when evaluating the objectivity of the pension consultants' recommendations and an explanation of why the question is relevant. DOL and the U.S. Securities and Exchange Commission developed the question to encourage the disclosure and review of more and better information about potential conflicts of interest. See DOL, EBSA, *Selecting and Monitoring Pension Consultants – Tips for Plan Fiduciaries* (Washington, D.C.: May 2005).

[60] See Proposed Revision of Annual Information/Reports, 81 Fed. Reg. 47,534, 47,564 (July 21, 2016). The Form 5500, among other things, is the primary means by which the federal government collects information on retirement plan assets. Plan sponsors are generally required to submit it as part of annual reporting requirements under ERISA and the Internal Revenue Code.

request for public comments on the potential costs and benefits of DOL collecting information on retirement plans' use of ESG factors. DOL also requests comments regarding the best way to collect standardized, comparable, and reliable information on the use of ESG factors by retirement plans.

The comment period for these proposed changes closed in December 2016. Of the 200 total comments received, DOL identified 6 that addressed both benefits and challenges of potentially collecting information about retirement plans' use of ESG factors. We reviewed the 6 comments and noted that potential benefits listed include increased transparency surrounding retirement plans' use of ESG factors and an increased potential for retirement plans to review and report a wider range of risk factors. Potential challenges listed included inconsistency in the terminology and definitions related to ESG factors, a lack of clarity regarding the appropriate criteria to evaluate ESG factors, and the absence of a single reporting standard for ESG factors. As of March 2018, DOL officials said that the agency is considering next steps on potential changes to the Form 5500 and did not provide a timeframe for further action.

Conclusions

ESG factors have emerged as a way for investors to assess potential risks and opportunities that otherwise may not be taken into account. Although this practice is not widespread, investors are increasingly using ESG factors, and the body of published research we reviewed suggests that such factors can be used in investment management without sacrificing financial performance, and potentially improving it. For example, retirement plans we reviewed in France, the Netherlands, and the United Kingdom use ESG factors to address a range of investment risks, in particular climate change and poor corporate governance. In the United States, however, available data suggest that few retirement plans are doing so outside of some of the largest public sector plans. Using ESG factors in the United States poses regulatory uncertainty, data difficulties, and other challenges.

DOL has issued interpretive bulletins that allow private sector retirement plans in the United States to consider ESG factors that are material to financial performance, but it does not provide additional information to clarify how fiduciaries for defined benefit and defined contribution plans may go about doing so. In particular, defined contribution plans—the predominant plan type in the United States—typically use a QDIA as a default investment option. Although DOL's guidance on ESG factors is broadly framed, comments from agency officials suggest that the application of ESG factors may be considered differently in a QDIA than in other fund types. The regulations pertaining to QDIAs predates DOL's 2015 and 2016 guidance on ESG factors and agency officials said plans face uncertainty in this area. Providing clarity on whether ESG factors could be used in a QDIA could help fiduciaries for defined contribution plans in managing risks for their primary investment option.

More broadly, additional information from DOL would also help fiduciaries for both defined benefit and defined contribution plans better understand steps they can take to effectively consider whether and how to use ESG factors not limited to QDIAs to address investment risks, including how to navigate the challenges of doing so. Without these actions, it may continue to be difficult for fiduciaries of private sector plans in the United States to take into account the full range of risks they consider material in managing plan assets.

Recommendations for Executive Action

We are making the following two recommendations to DOL:

- The Assistant Secretary of Labor for EBSA should clarify whether an ERISA plan may incorporate material ESG factors into the investment management for a qualified default investment alternative (QDIA). (Recommendation 1)
- The Assistant Secretary of Labor for EBSA should provide further information to assist fiduciaries in investment management involving ESG factors, including how to evaluate available options, such as questions to ask or items to consider. (Recommendation 2)

Agency Comments and Our Evaluation

We provided a draft of the report to the Department of Labor (DOL), the Federal Retirement Thrift Investment Board, the Pension Benefit Guaranty Corporation, the U.S. Department of State, the Department of the Treasury, and the Securities and Exchange Commission for their review and comment. In its comments, reproduced in appendix III, DOL neither agreed nor disagreed with the recommendations in this report. DOL and the Securities and Exchange Commission also provided technical comments, which we incorporated as appropriate. The Federal Retirement Thrift Investment Board, the Pension Benefit Guaranty Corporation, the U.S. Department of State, and the Department of the Treasury did not provide comments on this report.

DOL, in its written comments, stated that our report provided valuable research that will be carefully considered as the agency continues to review its efforts to assist plan sponsors, service providers, and others in complying with ERISA. Our report recommends that DOL take steps to (1) clarify whether plan fiduciaries may consider material ESG factors in designating an investment option as a Qualified Default Investment Alternative (QDIA) and (2) provide further information to assist fiduciaries in investment management involving ESG factors. On April 23, 2018, while DOL was reviewing our report, DOL issued Field Assistance Bulletin 2018-01 regarding retirement plans' use of ESG factors. Both the new field assistance bulletin and DOL's written comments on our report emphasize that plan fiduciaries are required to act prudently and in the best interest of participants when making investments decisions. The new field assistance bulletin generally reiterates that in considering the use of ESG factors, plan fiduciaries are not permitted to sacrifice investment returns or take on additional investment risk as a means of promoting collateral social policy goals—a position that is consistent with DOL's earlier guidance. The new field assistance bulletin states that fiduciaries must not too readily treat ESG factors as economically relevant, and includes information about the use of ESG factors in engagement activities, such as proxy voting. In discussing this new guidance, DOL officials told us that, consistent with ERISA and the evaluation of investment options generally, fiduciaries are required to conduct due diligence in evaluating ESG investment options in order to understand how they operate and to assess whether such options are in the best interest of plan participants. Indeed, we agree that such diligence is important when evaluating any investment option. Moreover, DOL's earlier guidance, as well as asset managers and representatives from public sector plans we interviewed, indicate that the use of ESG factors can help plans assess risks relevant to the plan's financial performance that may otherwise not be assessed.

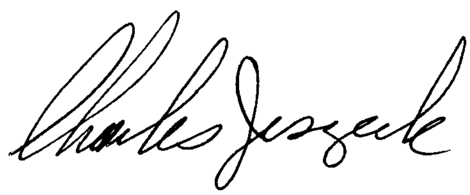
With respect to our first recommendation, our report recommends that DOL clarify whether fiduciaries may incorporate material ESG factors into the investment management of a QDIA. Unlike earlier guidance on the use of ESG factors, the new field assistance bulletin specifically mentions the use of ESG factors in a QDIA and reiterates the conditions under which an investment option may generally be considered a QDIA. However, the new field assistance bulletin's discussion of QDIAs focuses on the use of ESG factors for collateral benefits rather than on cases where ESG factors are considered in investment decisions because they have been determined by fiduciaries to be material to financial performance. For example, the new field assistance bulletin states that the QDIA regulations do not suggest that fiduciaries should select a QDIA based on collateral public policy goals. Research we reviewed along with detailed interviews we conducted with asset managers, retirement plan representatives, and industry stakeholders indicated that ESG factors can be used to address material risks, which might otherwise be ignored, and that there is interest in considering such factors within a QDIA. The use of ESG factors in this manner can be distinct from pursuing collateral public policy goals. Additional clarification from DOL that explicitly addresses plans' use of financially material ESG factors in investment options designated as a QDIA could enhance the agency's effectiveness in assisting plan fiduciaries with understanding and fulfilling their obligations under ERISA.

In addition, with respect to our second recommendation, we believe that while DOL's new field assistance bulletin provides information on the limitations of using ESG factors for pursuing collateral benefits, additional clarifying information from DOL could help sponsors conduct due diligence in considering whether ESG factors are material to an investment's financial performance and, if so, how to address those material risks. DOL's written comments recognize that additional clarification could be appropriate, depending on responses to the new field assistance bulletin from the public. We appreciate DOL's consideration of the need for additional information, particularly as some have noted the new field assistance bulletin could create a chilling effect that leads fiduciaries to avoid considering ESG factors that could address material risks in their investments, to the detriment of plan participants' best interests.

We are sending copies of this report to the Secretary of Labor, the Executive Director of the Federal Retirement Thrift Investment Board, the Director of the Pension Benefit Guaranty Corporation, the Secretary of State, the Secretary of the Treasury, and the Chair of the Securities and Exchange Commission. In addition, the report will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-7215 or jeszeckc@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

Sincerely yours,



Charles A. Jeszeck
Director, Education, Workforce, and Income Security Issues

Appendix I: Objectives, Scope, and Methodology

Our objectives for this review were to examine (1) the use of environmental, social, and governance (ESG) factors by retirement plans in the United States, (2) the use of ESG factors by selected retirement plans in other countries, and (3) the Department of Labor's (DOL) guidance on the use of ESG factors by private sector retirement plans in the United States.

To provide context about research on the relationship of ESG factors to financial performance, we conducted a literature review of studies that analyzed the financial performance of ESG strategies. To identify studies for this literature review, we conducted searches of various databases, such as EconLit, Proquest's Business Premium Collection, and Scopus. The search terms consisted of combinations of relevant terms including variations of ESG or sustainability and financial performance or return on investment. The search returned 205 studies. We limited our sample to studies that were published in peer reviewed academic journals or publications, analyzed the financial performance of ESG strategies in the United States, and were published from 2012 through 2017. The application of these criteria resulted in 11 studies for this literature review. Of these 11 studies, 9 conducted empirical analyses of investment scenarios with a collective total of 1,288 scenarios analyzed. These investment scenarios used different types of information to analyze the relationship between financial performance and variations of aggregate ESG scores or individual ESG factors. Specifically, 254 used an aggregate ESG score, 286 used specifically environmental information, 329 used specifically social information, 415 used specifically governance information, and 4 specifically used material ESG information. We then documented the authors' findings for each study and summarized the investment scenarios to provide evidence of the relationship between ESG and financial performance as documented in relevant literature.

To examine retirement plans' use of ESG factors in the United States, we conducted structured interviews with asset managers who have retirement plan clients to gather information on the types of ESG strategies used by retirement plans, the goals of such strategies, and their experience with implementation. We also interviewed ESG service providers, such as firms that provide research and ratings on ESG factors, and other knowledgeable stakeholders. The 7 asset managers who agreed to participate in our structured interviews were identified from a ranking of the 10 largest asset managers in 2016 published by Pensions & Investments based on assets under management for U.S.

institutional tax-exempt clients, which includes retirement savings plans, endowments, and foundations.[1] In addition, we interviewed 6 public sector retirement plans and reviewed plan documentation on their use of ESG factors in investment management. These included the 5 largest U.S. public sector retirement plans based on assets as ranked by *Pensions & Investments* for 2016. Specifically, the 5 largest public sector plans we interviewed were the federal Thrift Savings Plan, 3 plans for state employees and 1 plan for municipal employees. We also interviewed a smaller state plan at the recommendation of the National Association of State Retirement Administrators.

To examine the prevalence of the use of ESG factors by retirement plans in the United States, we reviewed available survey data from plan service providers and stakeholder groups and included questions in the structured interviews with asset managers about their retirement plan clients' utilization of ESG investment options. Nationally representative data on retirement plans' use of ESG factors is not available. The DOL collects nationally representative information on the assets of retirement plans through the Form 5500, but this form does not capture information on the use of ESG factors in a plan's investments. In the absence of nationally representative data, we identified two reports based on surveys with a relatively large sample size, but which only included defined contribution plans. Specifically, the Plan Sponsor Council of America's annual survey included about 600 defined contribution plans and Vanguard's *How America Saves 2017* report included about 1,900 defined contribution plans.[2] We also reviewed other reports based on survey data that included both defined contribution and defined benefit plans, but which had much smaller sample sizes and/or included other types of investors, such as endowments and foundations. Because these smaller surveys focused on ESG and participation was optional, the sample may not be representative of the population.

To examine how retirement plans in other countries incorporate ESG factors, we Interviewed representatives from selected plans in France, the Netherlands, and the United Kingdom, as well as government officials, service providers, and other stakeholders, and reviewed documentation.

[1] This was the most recent available data at the time of our review.

[2] See The Plan Sponsor Council of America, *60th Annual Survey of Profit-Sharing and 401(k) Plans* (February 2018) and The Vanguard Group, *How America Saves 2017: A Report on Vanguard 2016 Defined Contribution Plan Data* (June 2017).

To select these plans, we conducted an initial review of retirement plans in Organisation for Economic Co-operation and Development (OECD) countries highlighted for their use of ESG factors in available literature and consulted with experts at the OECD and the Council of Institutional Investors, among others. The selected plans included two hybrid defined benefit plans—Régime de Retraite Additionnelle de la Fonction Publique (RAFP) in France and Stichting Pensioenfonds ABP (ABP) in the Netherlands—and one defined contribution plan—the National Employment Savings Trust (NEST) in the United Kingdom. Each of the three plans use a different ESG strategy. We did not conduct an independent legal analysis to verify the information provided about the laws, regulations, or policies of the countries selected for this study. Instead, we relied on appropriate secondary sources, interviews, and other sources to support our work. We submitted key report excerpts to plan representatives in each country for their review and verification, and we incorporated their technical corrections as necessary. For more information on RAFP, ABP, and NEST, see appendix II.

To examine DOL's guidance for retirement plans' use of ESG factors in their investment management, we reviewed the relevant DOL guidance and other documents published by DOL. This included the interpretive bulletins that document DOL's interpretation of the relationship between fiduciary responsibilities and potential use of ESG factors. We interviewed DOL officials to discuss the relevant guidance and the status of any potential changes. In addition, we included questions about the interpretive bulletins in the structured interviews with asset managers to gather information on their perspective of DOL's guidance. We also reviewed DOL's qualified default investment alternatives regulations.

We conducted this performance audit from January 2017 to May 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Key Features of ESG Strategies for Selected Retirement Plans in France, the Netherlands, and the United Kingdom

To compile the information in this appendix, we Interviewed representatives from selected plans in France, the Netherlands, and the United Kingdom, as well as government officials, service providers, and other stakeholders, and reviewed documentation. We did not conduct an independent legal analysis to verify the information provided about the laws, regulations, or policies of the countries selected for this study. Instead, we relied on appropriate secondary sources, interviews, and other sources to support our work. We submitted key report excerpts to plan representatives in each country for their review and verification, and we incorporated their technical corrections as necessary.

France’s Régime de Retraite Additionnelle de la Fonction Publique

Environmental, Social, and Governance (ESG) Integration through a “Best in Class” Strategy

At a glance

France’s Régime de Retraite Additionnelle de la Fonction Publique (RAFP) is a retirement plan that supplements the basic pensions of French public sector employees. RAFP was established in 2005.

Plan type

Hybrid defined benefit plan—a plan that generally allows adjustments to both contributions and benefits depending on the plan’s funding level and provides monthly income in retirement.

Plan size

RAFP had over 45,000 employers, 4.5 million members, and €29.1 billion (approx. $35.7 billion) in assets under management in 2017.

ESG strategy

Integration and screening:

RAFP has systematically integrated ESG factors in its investment decisions for all asset classes using a “best in class” screening approach and tracking carbon emissions tied to its portfolio.

RAFP invests in assets it rates “best in class” on ESG factors specified in the plan’s investment policy, including management of environmental risk and good governance, transparency, and social factors.

Source: GAO analysis of plan documentation and interviews with government officials and plan representatives; U.S. State Department (base map); Art Explosion (flag).

Examples of ESG in practice

Global equities: RAFP relies on external managers to implement its “best in class” approach for incorporating ESG factors into its investment decisions for global equities, which accounted for 32 percent of its assets under management in 2017. RAFP’s external managers have discretion in selecting which sources of ESG ratings data they use in implementing RAFP’s “best in class” screening process. RAFP uses its own source for ESG ratings data, provided by a consultant, to help inform its supervision of its asset managers. As part of its ESG approach, RAFP has put a particular emphasis on climate change. For example, RAFP invested €100 million by the end of 2017 in global equity funds aimed at combatting climate change by investing in companies that offer products or services that could help cut carbon emissions.

Fixed income: RAFP also uses its “best in class” approach for fixed income assets, which account for about 57 percent of its assets under management—made up of sovereign, corporate, and convertible bonds. RAFP manages sovereign bonds itself while relying on external managers for the others. Along with the public companies for which it holds equities, RAFP also estimates the carbon emissions of bond issuers as it calculates the carbon footprint of its portfolio—which the plan uses as a measure of its climate risk.

Private Equity and Real estate: For its private equity and real estate assets, RAFP is working with a consultant to design a methodology for measuring and analyzing its exposure to climate change risks. RAFP expects to include the initial results of this work in its 2018 annual report.

Disclosure of ESG strategy

RAFP discloses information on its ESG strategy to regulators, participants, and stakeholders using multiple publicly available sources.

RAFP’s statement of its five charter values, which is publicly available, describes the key ESG factors that underly its “best in class” investment strategy. RAFP has specified a framework and criteria for implementing its “best in class” principle.

RAFP also describes its “best in class” strategy in annual investment reports provided to participants.

The Netherlands' Stichting Pensioenfonds ABP

Environmental, Social, and Governance (ESG) Integration and Inclusion Strategy

At a glance

The Dutch Pension Fund ABP (or Stichting Pensioenfonds ABP) is a retirement plan for public and education sector employees in the Netherlands.

Plan type

Hybrid defined benefit plan—a plan that generally allows adjustments to both contributions and benefits depending on the plan's funding level and provides monthly income in retirement.

Plan size

ABP had about 2.9 million participants and €411 billion (approx. $505 billion) in assets under management as of 2018.

ESG strategy

Integration and "inclusion":

ABP integrates specific targets for sustainable and responsible investing with their return targets across all asset classes using an inclusion-based strategy. ABP identifies material ESG factors, assesses how they are managed, and categorizes companies and issuers as either "leaders" or "laggards." The plan invests only in equities or bonds classified as leaders and a subgroup of those classified as laggards which it considers as having the potential to improve. The plan engages with companies which have been determined to insufficiently manage ESG factors. In 2016, ABP reported engagement with 245 companies on ESG factors, mostly related to governance.

Source: GAO analysis of plan documentation and interviews with government officials and the plan's asset manager; U.S. State Department (base map); Art Explosion (flag).

Examples of ESG in practice

Equities: ABP aims to invest only in equities of companies that are determined to be leaders in managing ESG factors by 2020. In addition, ABP is taking steps to reduce their carbon footprint—that is, the total amount of carbon emissions produced by companies held in their equity portfolio—by 25 percent by 2020 compared to 2014. To do so, ABP has set specific carbon budgets for the investment teams managing each individual equity portfolio and incrementally reduced the carbon budget over time in line with the 2020 goal.

Real estate: To assess ESG factors for current and prospective real estate investments, ABP uses the Global Real Estate Sustainability Benchmark (GRESB) survey—an annual comparative study which includes information on environmental and other ESG factors, such as workplace safety and involvement in bribery and corruption. For example, ABP uses GRESB data to track the energy and water consumption and carbon emissions of its real estate investments. ABP has also set specific targets for increasing sustainable investments, which primarily consist of real estate investments that rate in the highest category on the GRESB survey. As of 2016, €23.4 billion out of a total €41 billion in sustainable investments were held in such real estate investments.

Private equity: ABP coordinated with UN Principles for Responsible Investment to develop a questionnaire to assess potential investments in private equity funds. ABP uses the questionnaire to gather information on the fund's responsible investment policy, as well as implementation, reporting, and monitoring practices. ABP contributed material to the questionnaire to request information on climate change risks and other ESG factors to provide better oversight of how these factors are managed. ABP also worked with an association of private equity fund managers in Europe to develop a due-diligence questionnaire to be used by private equity fund managers to assess ESG factors when seeking to acquire a new portfolio company.

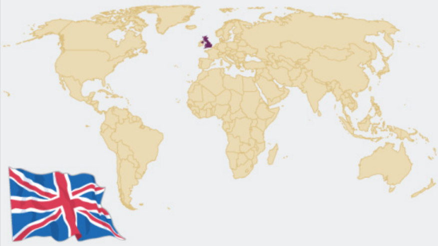
Disclosure of ESG strategy

ABP discloses information on their ESG strategy to regulators, participants, and stakeholders using multiple sources, including annual reports, meetings between the Board of Trustees and participants, webinars, position papers, and meetings with asset managers and other stakeholders. ABP also surveys plan participants about the plan's ESG strategy.

ABP's annual report includes a description of their Strategic Investment Plan and sustainable and responsible investment policy. ABP also issues an annual responsible investment report, which provides an overview of their ESG strategy and progress towards goals established for 2020, as well as specific examples of how ESG factors are used in practice.

The United Kingdom's National Employment Savings Trust

Environmental, Social, and Governance (ESG) Integration Strategy



At a glance

The National Employment Savings Trust (NEST) is a retirement plan established by the government and managed as an independent entity to help employers meet their obligation to automatically enroll eligible workers in a retirement plan. An employer may select NEST or offer their own plan. NEST began enrolling participants in 2012.

Plan type

Defined contribution.

Plan size

NEST had over 600,000 employers, 6 million members, and £2.3 billion (approx. $3.2 billion) in assets under management at the end of 2017.

ESG strategy

Integration:

NEST integrates ESG factors in the plan's default investment option for nearly all asset classes. The default investment option covers 99.8 percent of participants.

NEST works with their external asset managers to engage with corporations on ESG factors—for example meeting with corporate boards and voting on shareholder resolutions on issues such as executive compensation, gender diversity, and disclosure of climate change policies.

Source: GAO analysis of plan documentation and interviews with government officials and plan representatives; U.S. State Department (base map); Art Explosion (flag).

Examples of ESG in practice

Global equities: NEST worked with their asset manager to develop a fund which addresses climate change risks and opportunities. The Climate Aware Fund is benchmarked to a broad stock market index and weighted in favor of companies that rate more highly on certain ESG factors related to climate change. For example, companies are rated based on their greenhouse gas emissions and progress towards meeting targets set under the 2 degree Celsius scenario in the Paris Agreement. The fund does not exclude any companies from investment, but, rather, underweights the amount invested and seeks to engage with those that rate poorly against these ESG criteria.

Emerging markets equities: NEST's emerging markets fund uses an ESG screening process. According to NEST representatives, ESG risks can be particularly important in emerging markets, especially for issues such as governance, corruption, and the environment. NEST's asset manager identifies key ESG risks in the fund and screens out the companies with the lowest ratings.

Fixed income: NEST evaluates ESG risks for high yield bond issuers. When hiring asset managers, NEST solicited and evaluated information on how prospective managers incorporate ESG risk and opportunities into their decision-making and investment selection process. This included information on specific ESG factors NEST determined to be highly material, such as operations and governance structure, bribery and corruption, and climate change. NEST also examined how well the asset managers report to clients on these practices.

Real estate: For their real estate assets in the United Kingdom (UK), NEST's asset manager conducts an ESG risk assessment prior to acquiring a property and subsequently sets environmental performance targets for each property. As part of this process, the asset manager identifies specific properties in their portfolio with relatively high energy consumption compared to an established benchmark and develops a strategy to improve performance and monitor progress. The asset manager established an overall goal of a 20 percent reduction in energy, carbon, and water by 2020 compared to a baseline (2010 or the first year a property is owned).

Disclosure of ESG strategy

NEST discloses information on their ESG strategy to regulators, participants, and stakeholders using multiple publicly available sources.

NEST's statement of investment principles describes the use of ESG factors in the plan's investment strategy. The UK Pension's Regulator points to NEST's document as a resource for other plans.

NEST also describes its ESG strategy in quarterly and annual investment reports provided to participants.

Appendix III: Comments from the Department of Labor

U.S. Department of Labor

APR 2 7 2018

Assistant Secretary of
Employee Benefits Security Administration
Washington, D.C. 20210

Mr. Charles A. Jeszeck
Director, Education, Workforce, and Income Security
United States Government Accountability Office
Washington, DC 20548

Dear Mr. Jeszeck:

Thank you for the opportunity to review your draft report (GAO-18-398) entitled "Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance (ESG) Factors Would Be Helpful." The draft report examines the use of ESG factors in investments by retirement plans in the U.S. and other countries as well as the Department of Labor's (Department) guidance in this area to fiduciaries of private-sector U.S. retirement plans.

Although the Department's Employee Benefit Security Administration issued guidance in this area through interpretative bulletins in 2015 and 2016,[1] the draft report recommends that EBSA provide further guidance to assist ERISA plan fiduciaries in identifying and evaluating ESG factors when making investment decisions. The draft report also recommends that EBSA clarify whether ERISA plans may use an ESG investment fund as the plan's qualified default investment alternative (QDIA).[2]

Your recommendations are focused primarily on IB 2015-01. IB 2015-01 addresses the legal standard imposed by sections 403 and 404 of the Employee Retirement Income Security Act of 1974 (ERISA) with respect to a plan fiduciary's decision to invest plan assets in "economically targeted investments" (ETIs). ETIs are generally defined as investments that are selected for the economic benefits they create in addition to the investment return to the employee benefit plan. It has been the Department's longstanding position that ERISA's requirement that fiduciaries act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries prohibits plan fiduciaries from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives. The Department's objective in

[1] Interpretive Bulletin (IB) 2015-01 (codified at 29 CFR 2509.2015-01) and IB 2016-01 (codified at 29 CFR 2509.2601-01).

[2] The Department's QDIA regulation, 29 CFR 2550.404c-5, establishes conditions under which a participant or beneficiary in an individual account plan will be deemed to have exercised control over assets in his or her account when, in the absence of investment directions from the participant or beneficiary, the plan invests all or part of a participant's or beneficiary's account in a QDIA. The QDIA regulation describes the attributes necessary for an investment fund, product, model portfolio, or managed account to be QDIA. Each of the QDIA categories requires that the investment fund product, model portfolio, or investment management service apply generally accepted investment theories, be diversified so as to minimize the risk of large losses, and be designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures.

issuing guidance in this area[3] has been to assist plan fiduciaries in understanding their obligations under ERISA.

As we noted during the course of meetings on your study, the Department's leadership was independently reviewing the 2015 and 2016 IBs, and considering possible further actions in connection with those IBs. On April 23, 2018, EBSA released Field Assistance Bulletin (FAB) 2018-01 to assist EBSA's national and regional staff in addressing questions they may receive from plan fiduciaries and other interested stakeholders about the IBs. Although not technically issued in response to your report, the FAB includes discussions of issues raised in your report. The FAB is publicly available at www.dol.gov/ebsa. We are available to discuss the additional explanation of the Department's views expressed in the FAB.

We appreciate GAO's valuable research in this area summarized in the report. We also will carefully consider GAO's discussion of some of the central issues involved in the use of ESG factors in retirement plan investing as we continue the Department's ongoing compliance assistance program to help employers, plan officials, service providers, and others comply with ERISA. At this point, we believe it would be appropriate to evaluate the public reaction to your report and the FAB before reaching any conclusions about the necessity or appropriateness of issuing further guidance in this area.

Sincerely,

Preston Rutledge
Assistant Secretary

[3] When the Department published IB 2015-01 it included a long list of letters it issued in the 1980s and 1990s concerning a fiduciary's ability to consider the collateral effects of an investment and granted a variety of prohibited transaction exemptions to both individual plans and pooled investment vehicles involving investments, which produce collateral benefits. 80 Fed. Reg. 65134 n.1.

2

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Charles A. Jeszeck, (202) 512-7215 or jeszeckc@gao.gov

Staff Acknowledgments

In addition to the contact named above, Michael Collins (Assistant Director), Sharon Hermes (Analyst in Charge), Adrianne Cline, Laura Hoffrey, Christina Murphy, Steven Ray, and Seyda Wentworth made key contributions to this report.

Also contributing to this report were Joanna Berry, Deborah Bland, Leia Dickerson, Aimee Elivert, J. Alfredo Gómez, John Lack, Sheila McCoy, Rachel Stoiko, Joseph Dean Thompson, Kathleen van Gelder, Walter Vance, and Adam Wendel.

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