

# The Time to Lead is Now

The Adoption of ESG Analysis by Asian Government Pension Funds

July 2009



Toolkit  
Proxy Voting  
Infrastructure  
Country Profiles

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Association for Sustainable & Responsible Investment in Asia



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## The Adoption of ESG Analysis by Asian Government Pension Funds

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### Editorial team:

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### Disclaimer:

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## FOREWORD by ADB



Populations in Asia, notably in East Asia, are aging rapidly, putting public pensions systems around the region under serious strain. These systems could well fail to provide the elderly with the support that they require.

This trend comes at a critical time for the global economy, which is now suffering its biggest crisis since the Great Depression of the 1930s. The global economic crisis highlights the need for a worldwide rebalancing. For their part, Asian economies will need to move away from their past reliance on exports and excessive savings and toward greater domestic and regional consumption.

This will only occur, however, when economic growth rates pick up and when individuals have confidence that the social safety nets and pensions systems in their countries will provide for them in their time of need, be it when their health fails or when they get beyond working age. Thus, the economic crisis and the pensions crisis are closely intertwined.

As such, it is crucial for pension funds to maximize their returns and to do so in a way that directs investments into projects and activities that ensure the long-term sustainable development of Asia's economies, taking into account the region's often-fragile environment and its enormous human capital needs. Early and comprehensive retirement planning also provides one of the key foundations to financial sector development, which can help support broader economic progress.

This study by ASRIA, *The Time to Lead is Now: The Adoption of ESG Analysis by Asia Government Pension Funds*, represents a crucial first step in developing a framework to assist pension funds, their trustees, investment managers and advisers in this challenging environment. The Asian Development Bank (ADB) is delighted to have sponsored this report.

Each country profiled in the study has a public pension fund policy that is at a relatively early stage of development compared with global peers such as the United States, United Kingdom, and Australia. So now is an opportune time for these nations to adopt investment policies that use traditional investment analysis together with analysis that incorporates environmental, social and governance factors.

These objectives are in line with ADB's mission to help reduce poverty in its developing member countries and to improve the quality of life of their people through inclusive growth, environmentally sustainable growth and regional integration. In 2008, ADB approved US\$10.5 billion of loans, US\$811.4 million of grant projects, and technical assistance amounting to US\$274.5 million.

As the first work of its kind, we hope *The Time to Lead is Now: The Adoption of ESG Analysis by Asian Government Pension Funds* will stimulate healthy debate over the pace and pattern of growth of Asian pension funds, ensure they expand in a way that will best provide necessary support for individuals in the region as they reach old age, and pave the way for the region's long-term economic development.

### Philip Erquiaga

Director General, Private Sector Operations Department  
Asian Development Bank



## FOREWORD by ASrIA

ASrIA is pleased to present:

***“The Time to Lead is Now: The Adoption of ESG Analysis by Asian Government Pension Funds”.***



This Report is part of a wider process being conducted by ASrIA to engage with Asia's pension funds, their investment officers and trustees, as well as with the pension fund industry as a whole including the regulators and other stakeholders. The aim is to provide a roadmap for responsible investment, and so facilitate and accelerate the pace with which environmental, social and governance (ESG) practices are adopted in this part of the world. Asia's pension funds are among the largest and fastest growing pools of capital in the region and their influence in the capital markets will continue to grow, especially as asset allocations diversify and a broader range of sub-advisers pitch for their business.

At the same time, sustainability issues in the region are becoming better understood for their materiality and impacts on economic development. Whether it is the negative impact on earnings of poor standards in supply chains for example, or the positive opportunities in clean energy and carbon markets, the integration of ESG criteria into investment decisions is recognized by astute investors as an essential part of investment due-diligence and strategy. With their long-term investment obligations, pension funds have an inherent self-interest to foster better analysis of these issues in Asian markets. By so doing the funds complement their primary social purpose as part of the region's emergent security net, meeting the needs of Asia's rapidly aging population.

Through our research into best practice by pension funds across the world it is clear that more funds, especially some of the larger ones, are adopting a wide range of ESG practices and methods in managing their portfolios. Already a few Asian pension funds are adopting some aspects of ESG practice although activities are mostly at an early stage. By drawing on the tools and case-studies described in this report and by engaging in ASrIA's program we aim to help funds take further steps in developing manageable and effective ESG practices.

Due care and diligence has been taken to ensure that, as much as possible, this research uses practical examples to illustrate the main points. The hope and intention is that our findings will serve to stimulate, challenge, educate and motivate the industry to lead by example and to share experience with Asia's other asset owners, such as sovereign wealth funds and family offices. The report is relevant to a wide audience, including investment managers, stock analysts and researchers, investment bankers, financial advisers, consulting actuaries, government bodies, trustees, stock exchanges, media, investors, listed companies and others wishing to see the responsible deployment of investment capital.

At this time of economic recession, Asian economies are playing a leading role in efforts to bring about a global economic recovery. It is heartening to see a growing awareness among some of Asia's leaders that investment decisions must also be sustainable in order to prevent the current crisis being overtaken by even greater ecological and social constraints. This is not about returning to 'pre-crisis business as normal', this is about re-instating the original sustainable wealth generating purpose of investment. Pension funds hold the key to unlocking the influence and resources of the investment community to support this goal.

The time to act is now. The Time to Lead is Now.

**Tessa Tennant**

Founding Chair and Director, ASrIA

# The Time to Lead is Now

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## Executive Summary

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Wai-Shin Chan  
Executive Director  
ASRIA

## EXECUTIVE SUMMARY

As markets move on through the aftermath of the global financial crisis, it is clear that a transformation has occurred in the global investment landscape. Looking forward over the next five years and beyond, not only will Asian economies create a dramatic new range of investment opportunities, but Asian pension funds will see unprecedented growth as they seek to meet the retirement income needs of rapidly growing and aging populations. This will not be a small challenge. Pension funds have unique fiduciary obligations, while their activities may play a prominent role in helping to establish investment standards in rapidly changing capital markets.

Over the last two decades, a number of leading global pension funds have developed a range of policies and strategies to address fiduciary issues linked to sustainability. They have focused on specific environmental, social and governance (ESG) factors through the development of proxy voting policies, risk mitigation investment guidelines and the encouragement of specialty funds to target opportunities in new sectors such as clean tech and water. Increasingly, global pension funds also act collectively to encourage corporate disclosure on ESG performance and to support their common aim for understanding complex policy issues.

One key finding of this report is that the country level context is critical. There is no one roadmap for implementing responsible investment policies, only a set of tested tools and strategies which have increasing relevance to Asian governments seeking to encourage sustainable growth.

Over the next decade, we expect to see significant policy developments across Asia to address climate change, ecosystem destruction, pollution and a range of associated social impacts. Together with important infrastructure needs, these policies will have significant impacts on the investment climate for Asian pension funds.

It is our hope that ***The Time to Lead is Now: The Adoption of ESG Analysis by Asian Government Pension Funds*** will provide users with the tools to understand how pension funds can act as catalysts for sustainable development in a manner that is in full harmony with their fiduciary investment responsibilities and to provide the analytical framework for responsible investment (RI) by these pension funds. This is critical because Asian investors will certainly play a growing role in the global dialogue about responsible investment and, as a result, it is essential that this important discussion begins to reflect the goals of Asia's leading pension funds.

## Main Findings

- **Global adoption of asset diversification and ESG factors:** Increasing numbers of global pension funds are diversifying into all asset classes, including equities, in order to meet long term performance returns and balance risk; funds are also adopting aspects of ESG into their investments and a wide range of ESG best practice can be identified.
- **Asian funds have the opportunity to leapfrog:** Although some Asian pension funds are leading the way, most are lagging in ESG adoption and hence have the opportunity to adopt ESG strategies now and leapfrog to become global leaders. Taking a lead in fostering the adoption of ESG best practice among fund managers via tenders and pension investment policies is crucial.
- **Longer time horizons:** In taking the long term perspective, pension funds have the opportunity to prioritise investments which demonstrate sustainability, and to influence strategic decision making – a significant issue in Asia, where development of major infrastructure is ongoing.
- **Proxy voting as a fiduciary duty:** Proxy voting is increasingly being recognised as an important part of due diligence; the regulatory environment in Asia is gradually changing to reflect this.
- **Disclosure and corporate ESG strategies:** Asian pension funds can play an important role in helping to improve corporate disclosure in Asia. These pension funds, by the collective size of their investments, can encourage corporations to give more prominence to longer term and ESG issues in their corporate strategies and reporting.

### Diversification in pension funds & global ESG adoption

Asian pension funds have typically tended to be very conservative in their choice of asset mix, and have invested mostly in highly liquid instruments and government securities. Fixed income investments are necessary to match, or closely match, liability outflows; they are not, however, a substitute for equities when it comes to delivering longer term, enhanced returns and there is growing financial pressure on pension funds to invest a greater percentage of their assets in higher yielding asset classes.

This report provides many examples of the extent to which a wide range of leading global pension funds are adopting ESG criteria into their investment policies. RI puts an emphasis on the analysis of sustainability issues, such as climate change, which by their very nature have the potential to materially influence the value of a company's long-term assets and liabilities as well as the viability of business strategies. As pension fund investors seek to match their liabilities with long-term returns, they need to identify investments which demonstrate security and longevity in the face of fundamental environmental and social challenges.

The primary objective of pension fund trustees is to safeguard the fund's financial interests and part of their responsibilities includes taking steps to ensure that companies in which they invest act in a manner that protects shareholders' long-term interests. Trustees will increasingly face non-financial risks that are material to fund performance and they will come under increasing pressure to understand

and manage the many financial and extra-financial risks that companies face.

### Asian funds have the opportunity to leapfrog

Several large state pension funds in Asia are taking a lead in their respective markets by developing corporate governance guidelines and/or proxy voting policies. This group includes the National Pension Corporation in Korea (NPC Korea), Employees' Provident Fund in Malaysia, Government Pension Fund in Thailand (GPF Thailand) and the National Social Security Fund in China (SSF). With regards to the adoption of ESG strategies, however, most Asian pension funds are way behind the curve. This presents a timing opportunity whereby with renewed strategic focus and commitment to embracing best practice for ESG adoption, Asian pension funds could leapfrog to become global leaders. The fact that Asian pension funds' assets are mostly invested in domestic government and corporate bonds is to their advantage because it means that ESG analysis can be incorporated into the equity investment process from the outset, which was not the case with many of the other global pension funds.

### Longer time horizons

The Asian Development Bank expects US\$3 trillion to be spent on infrastructure over the next decade with 70% of the spending expected to come from the public sector. Investment in infrastructure projects and assets are typically long-lived and generate stable yields over longer time periods, making them well-suited to the yield requirements of pension funds.

One encouraging trend that this report highlights is that leading pension fund investors in infrastructure funds are now becoming more focused on key sustainability risk factors when they undertake their due diligence process. One driver of this trend is that signatories to the Equator Principles are expected to undertake environmental impact assessments for high impact projects. Evaluation of social impacts, particularly resettlement risks, is common when large-scale projects will result in land acquisition and the disruption of traditional communities, which may lead to legal challenges or other time delays. It is essential that pension fund trustees and investment managers factor these risks into their decision making processes.

While infrastructure funds have gained momentum, investment managers in this asset class have yet to develop their own specific set of transparent and systematic assessment tools relevant to examining sustainability issues, largely because the level of understanding amongst sponsors and investors is still evolving. The pension industry is now well positioned to encourage enhanced due diligence on sustainability variables and more pro-active strategies by infrastructure fund managers.

### Proxy voting as a fiduciary duty

Fiduciary duties are duties imposed upon a person or organisation that exercises some discretionary power in the interests of another person, in circumstances that give rise to a relationship of trust and confidence. It is the primary fiduciary duty of a pension fund to carry out investment decisions in the interests of its beneficiaries, acting prudently and in accordance with its governing documents.

There has been a great deal of debate about whether integration of ESG issues into the investment process of a pension fund is in compliance with the fiduciary duty of the trustees and professional staff. Trustees interested in considering an RI approach have in the past encountered resistance on the basis of a belief that institutional principals and their agents are legally prevented from taking account of such issues. However, with the growing body of evidence that ESG issues can have a material impact on the financial performance of securities, this view is gradually losing support.

The exercise of proxy voting rights has been emerging as perhaps the most common expression of responsible investment. As part of their fiduciary obligations to their beneficiaries, pension funds are expected either to vote proxies themselves or to instruct their asset managers how to vote on fundamental matters of corporate governance. The focus by pension funds is on endeavours to support improved board structures and to participate in decisions affecting major changes in capital or corporate structure and strategic direction. Owing to their long-term time horizons, pension funds can make a real impact on the behaviour of management if they participate in regular dialogue and responsibly use their proxy votes at every opportunity.

Governments, regulatory bodies and stock exchanges play an important role in enhancing governance and setting the framework to permit good practice relating to proxy voting. In 2003, The United States Securities and Exchange Commission (SEC) moved to categorise proxy voting as a fiduciary duty by requiring that trustees exercise the same degree of care relating to voting as in the management of funds. It adopted regulations on proxy voting by mutual funds and investment advisers and required them to disclose their policies and procedures for voting, and to report their actual vote. The result is greater emphasis on investor transparency and accountability, thus improving investor governance and corporate governance. The focus on Asian pension fund proxy voting policies is expected to increase and intensify with time.

## Disclosure and corporate ESG strategies

Asia's public pension funds can also play an important role in encouraging corporations to improve on their overall levels of disclosure. These funds can also guide the management of listed companies to focus more on internal ESG strategies and the reporting of these strategies. There are examples of listed companies adopting best practice in a variety of disciplines of their own volition, and this is to be applauded. In other instances, however, where listed companies are resistant to change and reluctant to adapt the strategies of their global peers, gradual and persistent encouragement is required from their shareholders.

The sheer scale of Asia's public pension funds means that as they diversify their investments into listed equities, they can play a very important role in working with other investors to encourage listed corporations to be exemplary in their ESG strategies. This is a change that can take time but with a concerted, dedicated approach pension funds, other investors and regulators can work hand in hand with senior management of listed companies to ensure long term performance for all parties.



## Conclusions

Many of the topics mentioned in this report will be new topics for consideration by Asian public pension funds. The initial outreach meetings that have been hosted with the Asian pension funds mentioned in this report indicate that receptiveness to learning and adopting these techniques into the investment process certainly exists. As investors, educators, corporations and government policy advisors work in collaboration with Asia's public pension funds, one can expect that Asia's pension funds will emerge as world class in this field. It is necessary to begin as soon as possible the training and education of pension fund analysts, managers and trustees.

*ASRIA seeks to encourage all relevant parties to take a role in supporting this process. Your support in this endeavour will be the key to success for Asia's pensioners and retirees.*