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BUILD ROBUST ESG POLICIES

Driving Alignment to Long-Term Sustainability Goals

The Need for a Robust ESG Policy

As environmental, social, and governance (ESG) considerations have now become more integrated into the investment decision-making process, investors should develop well-structured ESG investment policies to ensure accountability, transparency and impact. A robust investment policy statement or guidelines not only defines an organisation's commitment to responsible investing but also establishes a clear framework for integrating ESG considerations into the investment process.

In the third paper of the series 'Implementing an Effective ESG Framework', we outline the key components of an effective ESG investment policy, including setting clear objectives, selecting an appropriate approach, defining measurement criteria, conducting due diligence, embedding governance structures, continuous monitoring and transparent reporting. By following these principles, allocators can build a policy that aligns with their broader investment strategy while meeting regulatory requirements and stakeholder expectations.

Defining the Policy's Purpose

The first paper *Determining ESG Objectives*, highlighted the importance of clearly defining the purpose of an ESG investment policy. A well-structured policy should specify whether it focuses on a particular ESG objective or integrates ESG considerations within a broader risk and investment framework. If the policy prioritises specific ESG goals – such as carbon neutrality, board diversity, or ethical supply chains – it should state them explicitly.

Allocators can define their ESG objectives in different ways:

INTEGRATION

Integrating environmental, social and governance considerations across business activities and investments as one of many risk factors in investment decision-making.

EXCLUSIONS

Allocators exclude certain industries, such as tobacco or gambling, or issuers based on compliance with principles such as the UN Global Compact.

THEMATIC

Investing in themes, such as energy efficiency or a low carbon transition.

These tools can be used separately, or in a complementary way within portfolio construction. There is no single correct approach, but a robust policy should clearly define its objectives. Goals that are clearly articulated can provide essential context for the rest of the policy and ensures alignment with broader investment strategies.

Crafting a Tailored Investment Strategy

There is no "one-size fits all" approach to incorporating ESG considerations into the investment process; the appropriate strategy depends on the investment universe, available resources and the underlying objectives of the portfolio.

Strategy selection can be informed by the guidelines that have been established, taking into consideration which of the above tools is available and cost effective per asset class. Alone, each strategy can be considered based on its individual investment philosophy and approach to integration, exclusions or thematic investing, and can be analysed based on alignment to the guidelines. Together, they can be assessed at the portfolio level to consider how the overall investment objectives align with the ESG investment policy goals.

In addition to these tools, investors may also review strategies based on their approach to stewardship. Stewardship, such as voting proxies and corporate engagement, is another approach that investors can leverage to encourage the companies in their investment portfolios to manage sustainability related risks and conduct business practices that are consistent with long term sustainable value creation. It can be a standalone strategy or combined with other approaches.

Each approach holds value and should be employed to align with the objective. The policy should briefly outline how the chosen approach contributes to achieving the stated goals.

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Setting Clear Measurement Criteria

In the second paper *Defining Measurement Criteria*, we outlined key considerations for selecting data and measurement criteria. A critical component of this process is developing a thorough understanding of the methodology used by vendors to track alignment versus time-boxed targets.

A robust policy can specify preferred data sources or analytical frameworks used to assess its effectiveness and include a summary of the due diligence conducted on vendors, along with an explanation of their methodologies.

Additionally, the policy should define any key metrics that will be measured or used to shape the portfolio's investment universe, such as carbon footprints, board diversity, human rights impact scores or related indexes. This supports a transparent and structured approach to evaluating performance and impact.

Maintaining Accountability

A robust ESG framework requires thorough due diligence to validate that investments align with the policy. The depth of this due diligence depends on the policy's objectives—for example, allocators with explicit ESG goals should conduct more detailed assessments, while those incorporating more general ESG considerations may take a more high-level approach.

Appropriate due diligence should take place before making an investment. This could involve a comprehensive review of the third-party managers' ESG policies, checking that they align with key principles outlined in this paper. It should also include an evaluation of governance structures, as well as a review of investment committee memos and minutes to confirm that ESG considerations are actively integrated into decision-making.

Performing ongoing due diligence is equally important to evidence that investments continue to appropriately align over time. This involves monitoring changes to related policies and verifying that investment decisions remain consistent with sustainability commitments.

A robust policy should outline the due diligence process in detail, including the scope, methodology, and frequency of both initial and ongoing reviews.

Embedding Good Governance

An effective ESG investment policy must be actionable, clearly outlining how goals are integrated into the investment process. Strong governance is essential for accountability and consistency in decision-making. This section of the policy could include details on the following:

RESPONSIBILITY
Identify who is responsible for assessing an investment's alignment with the policy.

DATA COLLECTION
Specify what ESG-related data are needed to be gathered before making an investment.

INVESTMENT COMMITTEE DOCUMENTATION
Outline the ESG information that needs to be included in investment committee memos.

DECISION MAKING PROCESS
Confirm that ESG goals will be considered as part of investment decisions.

GOVERNANCE OVERSIGHT
Define which governance forums will oversee the policy and ensure adherence.

This section requires careful structuring to achieve the right balance – providing sufficient detail to sustain a rigorous process while maintaining the efficiency of capital allocation.

Reporting and Communicating Progress Transparently

The final section of an ESG investment policy should outline the transparency and reporting framework to demonstrate accountability and keep stakeholders informed about progress toward sustainability goals. This may include:

INTERNAL REPORTING

Regular updates to governance forums, including the board of trustees or equivalent, to assess adherence to the policy and to track progress.

STAKEHOLDER AND BENEFICIARY REPORTING

Providing ESG-related updates to end investors and other beneficiaries. This may take the form of monthly or quarterly reports or be streamlined into annual reports and annual general meetings.

REGULATORY REPORTING

Compliance with regulatory transparency requirements such as those focused on climate risk or other jurisdiction-specific environmental or social disclosure obligations.

Clearly defining the reporting structure helps internal and external stakeholders understand the level of transparency they can expect in relation to sustainability commitments and performance.

Strengthening ESG Integration for Long-Term Impact

A well-defined investment policy serves as the foundation for responsible investing, providing clarity on objectives, implementation strategies and governance oversight. By carefully selecting an approach that aligns with investment goals, establishing measurable criteria and embedding sustainability considerations into decision-making processes, allocators can deliver meaningful long-term value.

Transparency is also critical. Allocators should communicate sustainability performance effectively to internal governance bodies, stakeholders and regulators to build trust and demonstrate accountability. Ongoing due diligence and stewardship efforts help support commitments remaining relevant and impactful over time.

Ultimately, the concept of ESG and sustainability factors are not a static framework but an evolving practice that must adapt to emerging risks, opportunities, reputational risks and regulatory developments. By continuously refining policies and staying engaged with industry best practices, allocators can help drive meaningful change while achieving sustainable investment outcomes.

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About Northern Trust

With more than 1,800 global asset owner clients, across corporations, not-for-profits, public funds, insurance companies, central banks and sovereign wealth funds, Northern Trust has an unwavering and longstanding commitment to support the increasingly sophisticated needs of complex asset owners and allocators.

Our goal within the Asset Owner segment at Northern Trust is to empower the missions of our clients, helping them to maximise investment returns so that they may then serve their constituents, their communities and the world we live in.

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About ORC

ORC provides cutting-edge advisory services to institutional allocators and investment managers globally. With assets under advisement of over USD1.5 trillion, we support our clients with comprehending and managing their end-to-end risk landscape, including ESG.

ORC's range of solutions encompasses ESG framework design, ESG due diligence, operational due diligence and custody and fund administrator selection and monitoring. We leverage sophisticated technology to provide efficient and cost-effective solutions to our clients whilst adhering to a robust framework that ensures the quality of our work.

Complexity is a language we speak fluently; we leverage our senior team's over 100 years of practical experience to proactively raise institutional investment standards.

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