REPORT FOR:	**Pension Fund Committee**
Date of Meeting:	25 November 2015
Subject:	Environmental, Social and Governance Issues in Pension Fund Investment
Responsible Officer:	Dawn Calvert, Director of Finance
Exempt:	No
Wards affected:	All
Enclosures:	Appendix I: Advice to Shadow Scheme Advisory Board on fiduciary duty (2 April 2014) Appendix II: Kay Review and Law Commission Report Appendix III: The UN Principles for Responsible Investment (PRI); The UK Stewardship Code

Section 1 – Summary and Recommendations

Summary

This report advises the Committee of recent developments in the context of environmental, social and governance issues in pension fund investments and recommends the enhancement of the Fund's activities in this area.

Recommendations

The Committee are recommended to agree that:

1. Investment managers be asked to advise whether they have signed up to UN Principles for Responsible Investment (PRI)

2. Investment managers be asked to confirm that they have signed up to "The UK Stewardship Code" and to provide reports on their engagement and voting actions.

3. In the light of the responses to recommendations (1) and (2), the Fund considers further whether to sign up to "The UK Stewardship Code" in its own right.

4. The Fund takes a more active involvement in the Local Authority Pension Fund Forum by attending meetings at a Member or officer level and by more specifically associating itself with various initiatives.

5. Within the Statement of Investment Principles the current paragraph on "social, environmental or ethical considerations" be amended in accordance with paragraph 27 of this report.

Section 2 – Report

6. Over the years the matters considered in this report have been referred to as "socially responsible investment," "ethical investment" "social, ethical or environmental considerations," and other descriptions. Except where using a direct quotation, in this report they will be referred to as Environmental, Social and Governance (ESG) issues.

"Legislative" Background

7. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 state as follows:

Statement of investment principles

12.—*(1) An administering authority must, after consultation with such persons as it considers appropriate, prepare, maintain (in accordance with paragraph (5)) and publish a written statement of the principles governing its decisions about the investment of fund money.*

(2) The statement must cover its policy on—

……………………………………………

(f) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;

……………………………………………….

8. The Council's Statement of Investment Principles includes the following statement and reference to the compliance with the relevant "Myners" Principle:

Social, environmental or ethical considerations

10.1 The extent to which social, environmental and ethical considerations are taken into account in investment decisions is left to the discretion of the fund managers. However, the Council expects that investment return is seen as the priority and that the extent to which these considerations may have a financial impact on the portfolio will be taken into account by the fund managers in the exercise of their delegated duties. However, the Council expects the fund managers to engage positively and seek to influence companies in which the Fund invests to take account of key social, environmental and ethical considerations.

Compliance with "Myners' Principles

5 Responsible Ownership

Administering authorities should:

- *Adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents.*
- *Include a statement of their policy on responsible ownership in the Statement of Investment Principles.*
- *Report periodically to members on the discharge of such responsibilities.*

Fund compliance – Partial

- *The Fund's policy on the extent to which its investment managers take account of social, environmental and ethical considerations is stated in the Statement of Investment Principles.*
- *The Fund expects its managers to engage positively and seek to influence companies in which the Fund invests to take account of key social, environmental and ethical considerations.*
- *Where applicable, the Fund expects its managers to have adopted the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents.*

- *Whilst the Fund's equity holdings are wholly invested through pooled funds in which voting and engagement decisions are made by fund managers the Council encourages its managers to vote and engage with investee companies worldwide to ensure they comply with best practice in corporate governance in each locality. The fund managers provide reports on their voting and engagement activities.*

Previous Consideration by Pension Fund Investment Panel

9. Since it was established in 2013 the Pension Fund Committee has not considered a report specifically on ESG issues.

10. The Committee's predecessor, the Pension Fund Investment Panel, in response to publicity over the Fund's stance on tobacco related investments, received a report on 15 November 2011 entitled "Responsible Investing"

11. This paper did not make any recommendations but simply highlighted some of the issues associated with the term "Responsible Investing." The discussion of the Panel was minuted as follows:

    The Panel received the report of the Interim Director of Finance on the potential considerations with regard to responsible investment, following the recent media interest in this area.
    Members noted the information and expressed the view that as presented the report did not provide them with the level of detail and extent of legal advice to make a fully informed decision.
    The Interim Director of Finance advised that what was sought from Members was an indication of its preferred direction of travel, particularly as moves to a firmer ethical investment approach potentially had implications for the level of return gained on investments.
    A Member spoke on the need to gain Union input as part of any firm proposals to come forward as well as clear and definitive legal advice. A further comment made by another Member also questioned the assumptions with respect to Equalities Impacts.
    The Panel agreed the report was a summary of the current position and available alternatives but, that further work should be undertaken in terms of input and costed alternatives at a future meeting when submitted for reconsideration.
    RESOLVED: That the report be deferred to a future meeting and officers, as part of this, be requested to address the comments above.

External Legal Opinions

12. With the evolution of ESG issues over the years many Pension Funds have sought their own opinions as to the legality of various initiatives in respect of ESG issues. For example, negative screening of investments in companies involved in tobacco, alcohol, armaments and other industries has been the subject of several opinions.

13. However, with ESG issues now emerging as a more integrated part of investment policy and strategy, funds now have the benefit of recent opinions on fiduciary duty and ESG issues from Counsel advising the, then, LGPS Shadow Scheme Advisory Board and a report from the Law Commission.

14. Conclusions and commentary on these two opinions are given in Appendix I and Appendix II respectively.

Proposed actions by the Committee

15. There are various levels at which any Fund can promote ESG issues ranging from simple compliance with legislative requirements through to a high conviction approach which can involve personalized research and direct engagement with companies in which shares are held. However, notwithstanding the legal opinions discussed above, in view of the Committee's limited consideration of the issues to date and the fact that all its investments are through pooled vehicles, it is not being recommended that any major changes to its investment philosophy be made at this stage. However, it is recommended that various manageable initiatives be pursued.

16. There are two sets of principles which are widely accepted within investment circles as appropriate bases for the consideration of ESG issues as follows:
    - The UN Principles for Responsible Investment (PRI)
    - The Institutional Shareholders' Committee Code on the Responsibilities of Institutional Investors ("The UK Stewardship Code")

    The Principles / Code are detailed in Appendix III

17. The Council could sign up to the PRI but, whilst it can seek to follow the Principles, the reporting requirements are onerous and it would be difficult to sustain the accreditation.

18. Whilst the Council does not expect its investment managers to have signed up to the PRI it is believed that several of them have and it is recommended that they all be asked to confirm whether they have and to provide relevant evidence.

19. The Council already expects its investment managers to have signed up to "The UK Stewardship Code" and it is recommended that they all be asked to confirm whether they have and to provide relevant evidence. Managers would be specifically asked to provide reports on their engagement and voting actions and would become more accountable when met by the Committee.

20. It is also recommended that, in the light of the responses, the Fund considers further whether to sign up to "The UK Stewardship Code" in its own right.

21. The Fund is one of 64 funds who are members of the Local Authorities Pension Fund Forum (LAPFF). The mission statement of the Forum is:

> *The LAPFF exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest, commensurate with statutory regulations.*

22. The Forum actively engages with companies and institutional investors on a wide range of ESG issues including, in the last year, Carbon management, board diversity and remuneration.

23. Whilst the Fund has been a member of the Forum for many years it has not been active and on many occasions the Fund's representation at meetings and conferences has been limited to the co-opted member of the Committee or has been non-existent. It is therefore recommended that the Fund takes a more active involvement in the Forum by attending meetings at a Member or officer level and by more specifically associating itself with various initiatives.

24. In recent years substantial work has been done on the risks to the returns of pension funds of ignoring ESG factors. The risks identified include:

    - Climate change
    - Environmental destruction
    - Tobacco
    - Armaments
    - Governance of banks
    - Executive pay
    - The living wage
    - Modern slavery and supply chains

25. It is beyond the ability of the Council's Fund to provide specific support to the various campaigns linked to all these issues. However, there are initiatives taking place in the context of climate change to which the Council could lend its support. On a Global scale the issue is being discussed at a major conference in Paris in early December but at a more manageable level the Council could raise its concerns through requesting Carbon footprint of portfolios information from each of its managers and it is recommended that it does so.

Review of Statement of Investment Principles

26. In paragraph 3 above the Committee are advised of the paragraph on "social, environmental or ethical considerations" currently included in the Statement of Investment Principles.

27. In view of the points made above it is recommended that the paragraph be amended to read as follows:

The Council recognises that it has a paramount duty to seek to obtain the best possible return on the Fund’s investments taking into account a properly considered level of risk. As a general principle it considers that the long-term financial performance of a company in which it invests is likely to be enhanced if it follows good practice in its environmental, social and governance activities.

All the Fund’s investments are managed by external fund managers in pooled funds, one of which is passively managed, and the Council recognises the constraints inherent in this policy. Nevertheless it expects its managers, acting in the best financial interests of the Fund, to consider, amongst other factors, the effects of environmental, social and other issues on the performance of companies in which it invests. The Council expects its managers to have signed up to “The UK Stewardship Code” and to report regularly on their compliance with the Code and other relevant environmental, social and governance principles.

Financial Implications

28. The successful investment of the Pension Fund has wide implications and the matters arising from this report are intended to help to enhance returns.

Risk Management Implications

29. All of the Fund’s investment activities are recognized in the Pension Fund risk register and no decision will be taken without paying due regard to the risks involved.

Equalities implications

29. Investments taking into account environmental, governance and particularly social issues have considerable equalities implications but none arise directly from this report.

Council Priorities

30. Whilst the financial health of the Pension Fund directly affects the level of employer contribution which, in turn, affects the resources available for the Council’s priorities there are no impacts arising directly from this report.

Section 3 - Statutory Officer Clearance

Name: Dawn Calvert Date: 16 November 2015	✓	Chief Financial Officer
Name: Caroline Eccles Date: 16 November 2015	✓	on behalf of the Monitoring Officer

Ward Councillors notified:	**Not applicable**

Section 4 - Contact Details

Contact: Ian Talbot, Treasury and Pension Fund Manager
0208 424 1450

Background Papers - None

APPENDIX I

<u>Advice to Shadow Scheme Advisory Board on fiduciary duty (2 April 2014)</u>

The Local Government Association on behalf of the LGPS Shadow Scheme Advisory Board instructed Mr Nigel Giffin QC in the matter of:

I. Does an LGPS administering authority owe a fiduciary duty and if so to whom it is owed?

II. How should the wider functions, aims or objectives of the administering authority influence the discharge of its LGPS investment duties

His conclusions were

1. In managing an LGPS fund, the administering authority has both fiduciary duties and public law duties (which are in practice likely to come to much the same thing).

   This conclusion is clarified in the body of the opinion in paragraph 6 as follows:In my view the administering authority does owe fiduciary duties, both to the scheme employers, and to the scheme members

2. The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way).

3. However, so long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such considerations, the administering authority may not prefer its own particular interests to those of other scheme employers, and should not seek to impose its particular views where those would not be widely shared by scheme employers and members (nor may other scheme employers impose their views upon the administering authority).

So for example, in our view, an administering authority may choose to take into account the public health implications of tobacco investment but only if the result of such consideration is the replacement of these investments with assets producing a similar return.

Alternatively, in our view, an administering authority may take account of social housing needs but only if an investment in such stands up as an investment in its own right and can demonstrate that it is not preferring its own interests over other scheme employers in making the investment.

Furthermore, in our view, in making such decisions the administering authority cannot impose its view (on this or any other issue) on scheme employers nor can scheme employers impose their view on the administering authority if either resulted in a material risk to the return to and/or a suitable balance of assets in the fund.

APPENDIX II

Kay Review and Law Commission Report

In July 2012, Professor John Kay published his report "The Kay Review of UK equity markets and long-term decision making." This concluded a year-long review, commissioned by the Department for Business Innovation and Skills, considering the functioning of the UK's equity markets.

The Kay Review found significant uncertainty throughout the investment chain about the application of the legal concept of fiduciary duties. In particular, it found that some investment intermediaries were interpreting their duties to clients or to beneficiaries to mean the duty to maximise short-term financial returns, thus precluding consideration of factors which could impact on company performance, and therefore on investment performance, over the longer term.

The Government subsequently tasked the Law Commission to investigate fiduciary duties, including the extent to which fiduciaries including pension scheme trustees may, or must, consider:

• factors relevant to long-term investment performance which might not have an immediate financial impact, including questions of sustainability or environmental and social impact;

• interests beyond the maximisation of financial return; and

• generally prevailing ethical standards, and / or the ethical views of their beneficiaries, even where this may not be in the immediate financial interest of those beneficiaries.

The Law Commission published its final report "Fiduciary Duties of Investment Intermediaries" in July 2014. It concluded that trustees should take into account factors which are financially material to the performance of an investment, including over the long term. Where trustees think ethical or environmental, social or governance (ESG) issues are financially material they should take these into account.

The Law Commission also concluded that, while the pursuit of a financial return should be the predominant concern of pension trustees, the law is sufficiently flexible to allow other, non-financial, concerns to be taken into account provided trustees have good reason to think that scheme members share their view, and there is no risk of significant financial detriment to the fund.

In October 2014, the Government published its progress report on the implementation of the Kay Review. In it, the Government welcomed the Law Commission's conclusions on the consideration of long-term factors, as well as their view that trustees may make investment decisions based on non-financial factors in some circumstances.

APPENDIX III

THE UN PRINCIPLES FOR RESPONSIBLE INVESTMENT (PRI)

- We will incorporate ESG issues into investment analysis and decision-making processes
- We will be active owners and incorporate ESG issues into our ownership policies and practices
- We will seek appropriate disclosure on ESG issues by the entities in which we invest
- We will promote acceptance and implementation of the Principles with the investment industry
- We will work together to enhance our effectiveness in implementing the Principles
- We will report on our activities and progress towards implementing the Principles

THE INSTITUTIONAL SHAREHOLDERS COMMITTEE (ISC) CODE ON THE RESPONSIBILITIES OF INSTITUTIONAL INVESTORS ("THE UK STEWARDSHIP CODE")

- Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities
- Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
- Institutional investors should monitor their investee companies
- Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities as a method of protecting and enhancing shareholder value

- Institutional investors should be willing to act collectively with other investors where appropriate
- Institutional investors should have a clear policy on voting and disclosure of voting activity
- Institutional investors should report periodically on their stewardship and voting activities