UKSIF
UK Sustainable Investment and Finance Association

LGPS Reform
Department of Communities and Local Government
2S/E Quarter, Fry Building
2 Marsham Street
London
SW1P 4DF

19th February 2016

Dear Ms Edwards,

We are responding to the Department for Communities and Local Government's consultation on Revoking and Replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

UKSIF is the membership network for sustainable and responsible financial services in the UK. We promote and support sustainable and responsible investment (SRI) and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments. UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. We have around 240 members and affiliates including financial advisers, institutional and retail fund managers, pension funds (including LGPS funds), banks, research providers, consultants and NGOs. For more info about UKSIF, please visit www.uksif.org.

Introduction

On the whole the proposed changes to the LGPS Investment Regulations are positive. We were significant contributors to both the Kay Review[1] and the Law Commission report on fiduciary duties[2] and so were pleased to see responsible investment policies incorporated into the proposed Investment Strategy Statement. However we were disappointed to see that under these proposals savers will no longer be able to have their values reflected in their investments. We welcome the Government's approach to decluttering the regulations, but feel more can be done in this regard. The use of more precise language will lead to greater clarity for authorities on their responsibilities and duties.

Our overarching points are:

- That significant progress has been made in terms of requiring LGPS funds to take account of wider factors that are financially material such as environmental, social and governance factors, although more can and should be done.
- Although the Secretary of State's views on the use of pension policies to pursue boycotts, divestment and sanctions in relation to UK foreign policy have been made clear, this should not exclude authorities from considering other non-financial factors during the investment process.

[1] The Kay Review of UK Equity Markets and Long-Term Decision Making, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf
[2] Law Commission, *Fiduciary Duties of Investment* Intermediaries, para 6.30 available at http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf

- The consultation document and subsequent ministerial statements conflate non-financial factors with ESG factors. This is extremely concerning. Many fund managers in the UK now have entire teams tasked with analysing current and emerging environmental, social and governance factors to enable them to identify long-term risks and opportunities. This differs from investment decisions based on factors which are non-financial.
- More detail is needed on the Secretary of State's power of intervention. The Secretary of State should only ever intervene when an administering authority has breached its fiduciary duty. Rules should also acknowledge that this power will only be used with regard to investments based on non-financial factors (which does not mean ESG factors) that run contrary to UK foreign policy (i.e. incorporation of other non-financial factors is still legitimate).
- More detail is needed within the regulations on ESG and to encourage funds to adhere to international best practice. An expert working group should be set up to establish best practice and guidance should be published to reflect this.
- Pooling of funds will result in benefits of scale for some LGPS funds, and stewardship has rightly been recognised as enhancing the value of investments, however no details have been given on how stewardship activities will be conducted on investments from pooled funds. Each of the new British Wealth Funds should be required to sign the Stewardship Code and have their own policy on how stewardship duties will be carried out.

1. Responsible Investment

LGPS funds are responsible, long-term international investors. We would therefore welcome the use of the term 'responsible investment' in the regulations and a statement from funds on their approach to responsible investment which adheres to international best practice. Responsible investment is defined by the PRI as follows:

> *Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems.*[3]

What factors should be considered by administering authorities?

The Law Commission report on the fiduciary duties of investment intermediaries is heavily referenced throughout the consultation document and some of its recommendations form the basis for these proposals. The Law Commission said that trustees *should* take into account all financially material factors including ESG. It differentiated this group of factors from non-financial factors, by which it meant factors that 'might influence investment decisions motivated by other (non-financial) concerns such as showing disapproval of certain industries'.[4] The Secretary of State's views on whether this is an appropriate role for LGPS funds has been made clear. We welcomed the inclusion of the requirement for LGPS funds to have a policy on ESG. However, it concerned us to see paragraphs 3.7 and 3.8 in the consultation document, as well as subsequent announcements and statements by Government ministers, to seemingly conflate ESG factors and non-financial factors.

[3] Available at: http://www.unpri.org/introducing-responsible-investment/
[4] Law Commission, *Fiduciary Duties of Investment* Intermediaries, para 6.33, available at http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf

ESG factors may be financially material and where they are they *should* be taken into account. The consultation document notes that guidance on how ESG policies should reflect foreign policy and related issues will be published ahead of the new regulations coming into force. This was followed by the proposal to introduce a power for the Secretary of State to intervene in the investment function on a local authority where he determines the 'administering authority has failed to have regard to the regulations governing their investments or guidance issued under draft regulation 7(1)'. We are concerned that this potential confusion between what is and is not financially material could result in interventions by the Secretary of State where they are unnecessary, inappropriate and potentially very damaging to the fund and to members. Pensions are ultra-long-term investments. During the investment process factors which are financially material *should* be taken into account, regardless of the foreign policy of the Government of the day. It is unreasonable to expect pension funds, which have extremely long-term time horizons, to be expected to change their investment approach based on foreign policy potentially every five years.

A. Financially material factors:

> *'At its most basic, taking account of ESG factors is designed to reduce risks. The Kay Review highlights how poor safety procedures, together with a lack of environmental concern, may lead to disastrous and expensive mistakes. However, an ESG driven approach is not simply about avoiding the next company crisis. It works on the basis that companies do better in the long-term if they are well-run and sustainable, and have loyal suppliers, customers and employees.' – The Law Commission*

An investment strategy which incorporates ESG factors into the decision making process therefore helps to mitigate risks and enhance value. One example of a financially material factor is climate change: risks linked to it are financially material for investors. Increasingly, Governments, regulators and the public are starting to accept this. The COP21 negotiations have meant that we now have to limit global average temperature to 'well below' 2 degrees Celsius. Risks linked to this development have recently been recognised by the Governor of the Bank of England in his speech to Lloyd's when he referenced 'stranded assets' and the subsequent report by the Prudential Regulation Authority on climate related risks to the insurance industry. In France, the new Energy Transition law requires major financial institutions and companies to disclose the environmental and social impact of their investment policies. The Financial Stability Board has also set up a Task Force on Climate Related Disclosures for companies– a clear acknowledgement of the potential impact on businesses and investors from climate change.

Another recent example is the Volkswagen "test emissions" scandal – which resulted directly from corporate governance failings – and had a significantly detrimental impact on the company's share price, reducing it by more than 30%.[5] Several research providers had flagged VW governance failings in the months preceding the scandal and MSCI had put the company's score at 28% (meaning that it was lower than 72% of companies globally). For those investors who factored ESG concerns into their investment processes and either divested or did not invest as a result, relative losses were reduced or non-existent.

In both examples investors have been able to identify and analyse these issues as they emerged and acted on them as they saw appropriate. LGPS schemes that divest from fossil fuel holdings based on

[5] More information available at:
https://next.ft.com/stream/topicsId/MmRjZjgwMjYtMzMwYy00YzA5LTg0MDMtNTJjMWZiOWQyZDAx-VG9waWNz

financially material ESG factors are well within their rights to do so. Recent Government statements that penalties to stop councils divesting are being introduced "to ensure taxpayers' and the UK's interests are protected"[6] are extremely worrying and incoherent; tax payers stand to lose far more through continued investment in assets that will become "stranded". The valuation of coal and oil companies has plummeted over recent years and it is everyday savers who will lose significant portions of their pension pots if councils are not allowed to divest. This should not be about politically motivated investments, rather ensuring investment decisions are made in the best interests of savers.

B. Non-financial factors:

Non-financial factors are those which influence investment decisions based on non-financial concerns. Examples include improving members' quality of life or showing disapproval of certain industries. In the Law Commission's opinion, 'improving members' quality of life' was a legitimate factor in deciding whether to invest in local infrastructure projects.[7] It is worth noting that any administering authority which 'adopts a local approach to investment' is by definition making investment decisions based on non-financial factors.

The Law Commission gave a helpful example of the distinction between financially material factors and non-financial factors: Withdrawing from tobacco because the risk of litigation makes it a bad long-term investment is based on a financial factor. Withdrawing from tobacco because it is wrong to be associated with a product which kills people is based on a non-financial factor. Based on common law, the Law Commission made clear that non-financial factors may be taken into account provided two tests are met:

- Trustees should have good reason to think that scheme members would share the concern; and
- The decision should not involve a risk of significant financial detriment to the fund.

It is worth noting that an investment decision based on non-financial factors cannot be taken by a vote at a council meeting. What matters is the views of scheme members and that the above tests are applied. This is the case in private defined benefit schemes and it is unclear from the Government's arguments why this should not remain the case for LGPS funds. It also seems unreasonable that members of local government schemes should be put at a disadvantage in terms of their legal rights in relation to members of private DB schemes in this regard.

Power of Intervention

There is potential for significant issues stemming from the Secretary of State's power to intervene on investment decisions deemed to be contrary to the UK's foreign policy. These problems are further compounded when coupled with the apparent confusion surrounding factors that are financially material and those which are not. We have already made clear the difference between factors which are financially material and those which are not as described by the Law Commission.

It is not inconceivable that a similar situation to the one already described with Volkswagen could occur with a company based in e.g. Israel. There remains confusion for LGPS funds who may reasonably wish to

[6] http://www.theguardian.com/environment/2016/feb/18/uk-councils-warned-of-severe-penalties-of-fossil-fuel-divestment

[7] Law Commission, *Fiduciary Duties of Investment Intermediaries,* para 6.24 available at http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf

divest from the company based on the conflation in terms between financially material and non-financial factors and therefore whether the Secretary of State views this as being contrary to UK foreign policy. Clearly, however, the exact terms under which the Secretary of State may intervene in LGPS fund investment remain unknown and we look forward to their publication. It is vital this power is framed in terms of fiduciary duty. Only a breach of fiduciary duty should result in intervention by the Secretary of State.

This conflation of terms is extremely unhelpful and clarification is urgently needed. It is important therefore that guidance relating to how ethical investment policies should reflect UK foreign policy is consulted on at the earliest opportunity. If the Government is genuine about intervening in investment decisions relating to financially material ESG factors then it must ensure it has its own processes to determine the validity of investment decisions based on these factors and mechanisms through which it can horizon scan and identify emerging issues. However, if it is the Government's intention only to use the power of intervention in relation to decisions based on non-financial factors that run contrary to UK foreign policy it should make this clear, as decisions based on other non-financial factors (such as the tobacco example) will still be considered legitimate.

2. The LGPS Investment Regulations

We believe the Law Commission's report on the fiduciary duties of investment intermediaries should provide the foundation on which the responsibilities and duties of administering authorities in terms of their investment policies should be based. We would therefore welcome a stronger statement relating to the fiduciary duties of administering authorities within the regulations. This should require funds to adhere to national and international best practice- details of which may be kept updated in subsequent guidance.

Due to confusion over which factors were financially material and which were non-financial the Law Commission recommended clarification in the Occupational Pension Scheme Regulations- specifically within the Statement of Investment Principles. We have already welcomed the move to require administering authorities to have a policy on ESG and on stewardship in the new Investment Strategy Statement. The confusion on non-financial factors, however, should not prohibit such factors from being taken into account. We would therefore welcome a requirement in section 7(2) for administering authorities to include their policy on how they incorporate non-financial factors in investment decisions within the Investment Strategy Statement, even if this is subject to forthcoming guidance from DCLG in relation to investments contrary to UK foreign policy. Section 7(2)(e) should read 'the authority's policy on how social, environmental **and** corporate governance factors are taken into account in the selection, non-selection retention and realisation of investments'. It is standard best practice within the sector to incorporate all financially material factors including ESG, rather than to pick which financially material factors should be considered.

The Stewardship Code makes it clear that stewardship is more than just voting and may include monitoring and engagement with companies on strategy, performance, risk and corporate governance amongst other issues. Engagement is described as 'purposeful dialogue with companies on [the above] matters as well as on issues that are the immediate subject of votes at general meetings.' They therefore may influence corporate behaviours and long-term performance. Stewardship is therefore integral to a responsible investment approach and we welcome its inclusion in the regulation for administering authorities. Stewardship aims to promote the long-term success of companies in such a way that the

ultimate providers of capital also prosper. It benefits companies, investors and the economy as a whole.[8] We welcome the inclusion of section 7(2)(f) which requires the administering authority's investment strategy statement to include 'the authority's policy on the exercise of the rights (including the voting rights) attaching to investments'.

We echo the thoughts of the Environment Agency Pension Fund that an expert working group should be set up to support development of guidance and for DCLG to publish a further consultation to examine global best practice. UKSIF would be happy to offer support in the development of this guidance.

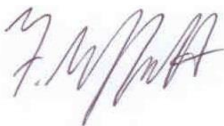
3. Asset Pooling

Responsible investment, including ESG and stewardship should be central to the investment governance of the Collective Investment Vehicles. We therefore look forward to seeing greater clarity on the Secretary of State's expectations on ESG and stewardship activities relating to pooled investments.

In particular we believe this should include compliance with best practice, as has already been called for by the Environment Agency Pension Fund.[9] Again, it is likely the most practical way to proceed is by calling for the CIVs to adhere to international best practice within the regulations and expand on details in continuously updated guidance. We would like to see rules which require a responsible investment lead for each CIV as well as other steps such as becoming a signatory to the UK Stewardship Code, signing up to the PRI or becoming an affiliate member of UKSIF. It would also be sensible for the CIVs to engage with or join national frameworks and collaborative initiatives to support cost effective stewardship through collective action such as the Local Authority Pension Fund Forum (LAPFF)[10].

We trust the above information is clear, but if you require clarification on any of the points raised please do not hesitate to contact us.

Yours sincerely,



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[8] Financial Reporting Council, *The UK Stewardship Code*, available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf
[9] Available here: https://www.eapf.org.uk/~/media/document-libraries/eapf2/policies/eapfs-response-to-management-and-investment-of-funds-regulations-and-annexes-v1.pdf?la=en
[10] More information available at: http://www.lapfforum.org/