UKSIF
UK Sustainable Investment and Finance Association

Policy update: Local Government Pension Scheme – Guidance on Preparing and Maintaining an Investment Strategy Statement

What has happened?

Following its consultation on new rules for LGPS funds last November, the Department for Communities and Local Government has now published follow-on guidance for administering authorities. The original consultation, *Revoking and Replacing the LGPS Regulations 2009*,[1] set out rules which would require authorities to have a new Investment Strategy Statement (ISS) to replace the Statement of Investment Principles. Last week guidance on preparing and maintaining an ISS was published by the Government which contains requirements relating to responsible investment.[2]

What does the Investment Strategy Statement require?

Regulation 7(1) requires an administering authority to formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State. The ISS must include (aspects relating to responsible investment in bold):

a) A requirement to invest money in a wide variety of investments;
b) The authority's assessment of the suitability of particular investments and types of investments;
c) The authority's approach to risk, including the ways in which risks are to be measured and managed;
d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;
e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

How does this relate to responsible investment?

Regulation 7(2)(b) requires inclusion of the administrative authority's assessment of the suitability or particular investments and types of investments. The guidance states that assessing the suitability of different investment classes involves a number of factors 'including, for example, performance benchmarks, appetite for risk, [the administering authority's] policy on non-financial factors and perhaps most importantly, funding strategy.'

UKSIF previously voiced concern at the apparent exclusion of reference to investment decisions based on non-financial factors.[3] In its 2014 report into fiduciary duties, the Law Commission was clear that these are legitimate and legally permissible factors on which to base investment decisions provided two tests are passed:

1. That there is good reason to think scheme members share the concern;
2. There is no risk of significant financial detriment to the fund. [4]

These factors may include improving members' quality of life, or showing disapproval of certain industries and we saw no reason why LGPS members should not be able to have their values reflected in their investments. UKSIF also urged caution over the apparent conflation between financially material and non-financial factors in the original consultation document. We welcome both of these concerns having now been addressed.

Regulation 7(2)(e) requires information on how ESG considerations are taken into account in the selection, non-selection, retention and realisation of investments. The Government has been clear it expects administering authorities to take a prudent approach to investments and we welcome this, but the guidance goes further: 'The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors'.

However, the guidance also states that 'using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.' This is summarised by stating administering authorities should not pursue policies that are contrary to UK foreign policy or UK defence policy. In the initial response to the DCLG consultation, UKSIF called for clarification on this point, particularly the extent to which pension fund investment policies with inherently ultra-long-term time horizons could be expected to align with the foreign policy of a sitting government.

In what appears to be some overlap with Regulation 7(2)(b), the guidance recognises that 'although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account' based on the two tests set out by the Law Commission. This is a welcome clarification and serves to outline the distinction between financially material and non-financial factors.

Finally, UKSIF welcomes the inclusion of a new paragraph on social investment. The guidance states, 'in some cases, the social impact is simply in addition to the financial return; for these investments the positive social impact will always be compatible with the prudent approach. In other cases, some part of the financial return may be forgone in order to generate social impact. These investments will also be compatible with the prudent approach' providing the two tests set out by the Law Commission are met.

Regulation 2(7)(f) requires a policy on the exercise of rights (including voting) attaching to investments. UKSIF welcomes the updated guidance which rightly recognises the benefits to investors stemming from good stewardship. The guidance also states that 'engagement enables administering authorities as long-term shareholders to exert a positive influence on companies… and drive improvements in the management of environmental, social and corporate governance issues'. In UKSIF's original submission, we called for a requirement that administering authorities should sign the Stewardship Code and we welcome the new expectation in the guidance that this will happen, as well as the more stringent regulation which requires all authorities to have a policy which reflects their stewardship responsibilities.

What else has UKSIF said on the guidance?

UKSIF welcomes our views having been taken into account on a range of issues as outlined above, but concerns remain over the new guidance, in particular the new power of Direction for the Secretary of State. The new rules on this come in Regulation 8 which includes a number of 'safeguards', which include consultation with the relevant authority to ensure the power is used appropriately, proportionately and where justified by evidence.

The power of Direction can be used in the following ways:

a) To require an administering authority to make changes to its investment strategy in a given timescale;
b) To require an administering authority to invest assets as specified in the Direction;
c) To transfer the investment functions of an administering authority to the Secretary of State or a nominated person;
d) To require an administering authority to comply with any instructions from either the Secretary of State or the appointed person in circumstances when the investment function has been transferred.

During the original consultation process UKSIF called for DCLG to clarify the circumstances in which this power could be used. We argued that it should only ever be used where an administering authority has breached its fiduciary duty. The Government has been clear, however, in stating that this regulation 'enables the Secretary of State to issue a Direction if he is satisfied that an administering authority is failing to act in accordance with this guidance'.

Next steps?

The Government has stated it will publish the new investment regulations later this year. Despite producing guidance before the regulations have been published, administering authorities are expected to have formulated their Investment Strategy Statements by April 1st 2017.

The LGPS guidance is available here.