



LOCAL PENSION COMMITTEE – 1ST SEPTEMBER 2017

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RESPONSIBLE INVESTMENT

Purpose of the Report

1. The purpose of this report is to provide the Committee with information in respect of the wide-ranging issue of Responsible Investment, to recommend approval of the LGPS Central's Responsible Investment Policy and that the Leicestershire Pension Fund become a member of the Local Authority Pension Fund Forum. Approval is also sought to enable the Director of Finance to determine whether or not the Leicestershire Pension Fund should become a signatory to Responsible Investment principles and initiatives.
2. The report also provides information to members concerning the referral of several LGPS Funds (including Leicestershire) to the Pensions Regulator regarding their investments and the potential risks they face as a result of climate change.

Background

3. The LGPS is a statutory pension scheme and, as such, does not have trustees. Leicestershire County Council is the Administering Authority for the Leicestershire Fund, and its responsibilities are discharged via the Local Pension Committee, the Investment Subcommittee and the Local Pension Board. These bodies, and the individuals that sit on them, are often referred to as quasi-trustees because they fulfil much the same role as that of a trustee; members of these bodies, however, do not have the personal liability for decisions taken in the same way that a trustee would normally have.
4. It is universally accepted that the Administering Authority has a responsibility to act as a trustee and a legal requirement to seek to obtain the highest possible investment return within acceptable levels of risk. The LGPS is a defined benefit pension scheme where the benefits are guaranteed (and based on a mixture of pensionable pay and service accrued), and investment returns have no impact on benefit levels of individual members. Employing bodies effectively bear the investment risks within the LGPS, and the level of investment returns will have a direct impact on their contribution rates.
5. The Local Pension Committee is able to exclude investment in certain types of assets if it wishes, as long as it is satisfied that this does not compromise the potential investment return or produce unduly high levels of risk. Exclusion

of investments must be based solely on a financial judgement, rather than being based on a moral perspective.

What is Responsible Investment

6. There are many definitions of Responsible Investment (RI), but the most commonly used one is that produced by the United Nations Principles for Responsible Investment (UNPRI):

“Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns.”

7. Some of the factors included in ESG, are as follows:

Environmental	Social	Governance
Climate change	Working conditions, including slavery and child labour	Executive pay
Greenhouse gas emissions	Local communities, including indigenous communities	Bribery and corruption
Resource depletion, including water	Conflict	Political lobbying and donations
Waste and pollution	Health and safety	Board diversity and structure
Deforestation	Employee relations and diversity	Tax strategy

8. The UNPRI is very clear that RI is not the same as Socially Responsible Investment. The major difference is that RI is not overlaid with any moral or ethical aspect, and is pursued simply because to ignore ESG factors is to ignore risks and opportunities that have a material effect on investment returns. RI is a holistic approach that aims to include any information that could be material to investment performance.

Current Fund Approach to Responsible Investment

9. The Fund has, for many years, satisfied itself that potential investment managers take account of RI as part of their decision-making processes before they are considered for appointment. The majority of investment managers have, in recent years, invested heavily in enhancing the resources available in the area of RI and have formally integrated RI issues into their investment decisions. Whilst the Fund has not become directly involved in RI issues, the investment managers have been active on its behalf.

LGPS Central Responsible Investment Policy

10. LGPS Central, the investment management company that has been set up to manage the assets of nine LGPS Funds (including the Leicestershire Fund) from 1st April 2018, must have a Responsible Investment Policy that is common to all nine Funds if it is going to deal with the issue of RI in an efficient and consistent manner. There are no meaningful differences between the Funds in terms of how they currently deal with RI so a Policy has been easy to develop, and the draft version is attached as an appendix to this report.
11. The RI Policy will ultimately be agreed by all the LGPS Central Shareholders and it is possible that there will be small changes to the draft Policy attached. However, in the event that there are any meaningful changes to the Policy a further report will be brought back to this Committee as appropriate.
12. The Responsible Investment Policy is not overly detailed and includes sufficient flexibility to deal with issues on a case-by-case basis. The major points of it are:
 - RI is considered to be relevant to all asset classes;
 - Whether the assets are managed internally or externally, there is a requirement that RI will be integrated in to the investment decision-making process. External investment managers that cannot fulfil this will not be utilised;
 - Engagement rather than exclusion is preferred. Retaining a position of influence as a shareholder is a better option than simply selling if there are issues at a company;
 - The policy will evolve in line with latest market developments in the area of RI;
 - Harnessing the influence of multiple investors is likely to bring better results and more speedy changes.
13. LGPS Central will employ its own RI resources and this will assist in ensuring that RI is fully integrated into the investment process, whether the assets are managed by LGPS Central itself or by investment managers that it has appointed.
14. In future it is expected that the reports produced for this Committee by LGPS Central will have a strong emphasis on RI issues and what actions are being taken to preserve and enhance shareholder value, or to mitigate some of the risks involved.

Membership of relevant trade bodies

15. Unlike the Leicestershire fund, the other eight Funds within LGPS Central are members of the Local Authority Pension Fund Forum (LAPFF). This is a collaborative shareholder engagement group with over 70 LGPS Fund members and over £200bn in combined assets. The LAPFF is likely to be heavily utilised in any shareholder engagement conducted by LGPS Central,

and it is not reasonable for the Leicestershire Fund to receive the benefit of any such work unless it becomes a member. Whilst there are currently discussions about the future membership fee policy of the LAPFF, the expected cost if the Leicestershire Fund was to join the Forum would be around £9,000 p.a.

16. There are some concerns about the way in which the LAPFF is currently structured and constituted, and in particular the potential for the organisation and its future direction to be overly influenced by certain individuals or Funds. It is expected that these concerns will ultimately be dealt with and, whilst it is recommended that the Leicestershire Fund join the Forum, it is considered sensible to defer such membership until the Director of Finance is satisfied that these concerns have been addressed.

Becoming a signatory to key initiatives and principles

17. The Leicestershire Fund has not historically become a direct signatory to certain key initiatives relating to RI, and has been comfortable that, as its investment managers have always been signatories, the Fund was adhering to the broad principles by default. However, under the new pooling arrangements that will come into place in 2018, it is now considered appropriate for the Leicestershire Fund to become a direct signatory similar to the other Funds within LGPS Central, particularly given the focus and resources within RI that LGPS Central will have. The most obvious example is the United Nations Principles for Responsible Investment (UNPRI), but there may be others where a direct signature is relevant.
18. There is no immediate requirement to become signatories, given that the Fund has operated effectively for many years without having done so. However, it is considered expedient for the Director of Finance to be authorised to sign up to those initiatives in the future that LGPS Central believe are appropriate and where the agreed RI Policy is clearly supportive of the initiative. Where there is any doubt about the compatibility of the RI Policy and a particular initiative, the Fund will not become a signatory without the prior approval of this Committee. This Committee will be notified of any relevant initiatives that the Fund signs up to.

Pressure from Pension Fund Members

19. Members of this Committee may be contacted on occasions by individual LGPS members with questions about the Fund's exposure to certain companies or industries, and these will often be accompanied with a suggestion that the Fund should divest from certain areas as the risks have not been appropriately assessed. In February 2017 a referral was made by ClientEarth and ShareAction to the Pensions Regulator entitled "The Local Government Pension Scheme and Climate Risk".
20. The basis of the referral was that the LGPS (or, more specifically, certain LGPS Funds) were operating under some misconceptions, were failing to comply with their legal duties and/or putting scheme members' savings at risk.

The Leicestershire Fund was quite heavily quoted in the report that accompanied the referral. A copy of the report can be found at:
<https://shareaction.org/wp-content/uploads/2017/04/TPRReferral.pdf>

21. One reason that the Leicestershire Fund was quoted throughout the report is because it provided a number of detailed responses to the questions asked, unlike many Funds that either did not reply or provided minimal levels of detail. Whilst all of the quotes are accurate, they are often a small part of a much longer response that loses its true meaning when taken out of context. Officers are comfortable that the fuller responses are a fair reflection of the Fund's activities and that there are no misconceptions, failures to comply with legal duties or any risk to members' savings at the Leicestershire Fund.
22. The issue that was included in the referral to the Pensions Regulator was climate change, and in particular a supposition that the LGPS is failing to take into account the risks that exist by holding shares in oil companies. More specifically, the argument is that in order to comply with agreed temperature increases it will be impossible for the reserves of oil companies to be used and they have balance sheets with billions of pounds attributed to assets that will ultimately prove worthless (or worse). These assets are generally referred to as 'stranded'.
23. It is, of course, entirely possible that the stranded assets issue may ultimately prove to be correct. But the issue is one that is fully in the minds of investors, and one that individual investment managers are capable of forming a judgement on. Market prices are the level at which buyers and sellers come together; if an investment manager does not believe the risks are fully factored into prices (and, hence, prices are too high) they are free to avoid the investment.
24. There is little doubt that climate change is one of the issues that investors face, but there are also many others. The Fund is entirely comfortable that its active investment managers have investment processes that include integrated assessment of the RI issues including climate change; furthermore it would be very surprising if they all came to the same conclusion about how much of a risk climate change is to the future prospects of oil companies.

Recommendations

25. It is recommended that the Local Pension Committee:
 - a) Approves the Responsible Investment Policy of the LGPS Central, attached as an appendix to this report;
 - b) Agrees that the Leicestershire Pension Fund becomes a member of the Local Authority Pension Fund Forum (LAPFF), subject to the Director of Finance being comfortable with its organisational structure and constitution;
 - c) That the Director of Finance be authorised to agree for the Leicestershire Pension Fund to become a direct signatory of those Responsible Investment

principles or initiatives aligned to the Responsible Investment Policy of the LGPS Central, including the United Nations Principles for Responsible Investment, noting that where there is any doubt about compatibility the Fund will not become a signatory without the approval of the Local Pension Committee.

Appendix

LGPS Central Responsible Investment

Equal Opportunities Implications

None specific

Background Papers

None

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