LAPFF Response to Changes to Investment Management Regulations: Embedding Responsible Investment Practice by Trustees

April 2015

Local Authority Pension Fund Forum

DWP: Changes to Investment Management Regulations: Embedding Responsible Investment Practice by Trustees

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 64 local authority pension funds based in the UK with combined assets of approximately £165 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

1. Changes to Investment Management Regulations: Embedding Responsible Investment Practice by Trustees

Comments from the Local Authority Pension Fund Forum

Background

LAPFF has responded to this consultation from the Department of Work and Pensions on those matters that it believes directly affect or have consequences for the investment activities of local authority pension funds and that have implications for the Local Government Pension Scheme investment management regulations, currently in place.

1.1 It is clear LGPS funds have the power to engage with the responsible investment (RI) agenda provided that their activities are reasonable, proportionate, minimise adverse investment risk impact and do not undermine long-term investment returns to their pension funds. Many LGPS funds (funds) believe and operate under the assumption that consideration and engagement on RI matters can be viewed as part of the essential stewardship role required of their funds in protecting the long term value of a fund's investment.

1.2 The investment activities of these funds are undertaken in accordance with the relevant regulations and legal opinions published on the interpretation of the law. The position for LGPS funds is set out in the relevant Investment Management Regulations specifically for the Scheme. They are similar to the regulations that relate to private sector occupational pension schemes (OPS), but are in some areas more restrictive. The LGPS regulations require funds to state their position on ESG matters in their Statement of Investment Principles (SIP), even if they intend taking no action. They are also required to take advice on investment matters.

1.3 Specifically the current regulations require LGPS Funds to produce a SIP that must include reference:

> "…(b) to the suitability of particular investments and types of investments…
>
> (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;… (g) the exercise of the rights (including voting rights) attaching to investments, if the authority has any such policy; …"

LGPS Funds are also required to take appropriate advice before making any investments.

> "…(5) The authority must obtain proper advice at reasonable intervals about its investments.
>
> (6) The authority must consider such advice in taking any steps in relation to its investments…"

1.4 The Law Commission's recent review of fiduciary duty concluded, in summary, that RI factors could be taken into account. Of course, it is now clear that many RI factors have financial consequences over time and impact both positively and negatively on the value of, and the risk/return ratio of an individual or portfolio of investment assets. This has prompted some to assert that, on this common sense approach, all investment activity and processes should consider RI factors as a matter of custom and practice. Some RI factors may be difficult to quantify in terms of their impact on investment return, but may nevertheless raise impacts on reputational risk for a fund, and its trustees, or policy factors that have adverse stakeholder impacts where appropriate action by trustees may be required, mitigated by the perceived adverse financial impact on a fund's sustainable investment returns.

1.5 The debate surrounding the LGPS regulations has reached similar conclusions with the additional concerns for trustees (pension committee elected members) to ensure that the potential for, or actual, conflicts of interest with their other roles as Councillors are identified.

1.6 Equally many of those with a stakeholder interest in a fund, such as current contributors, may equally want 'their money' managed to avoid, or mitigate, harm caused by the negative impact of 'irresponsible investment' (the opposite of Responsible Investment, or 'minusRI'), on individuals and communities. Some would go further and wish to see "their funds" used proactively to improve RI outcomes from the investment strategy pursued.

1.7 For many years the simple benchmark has been that trustees should act as a "prudent person", which has been taken to mean acting in a manner which maximises return whilst having regard to the level of risk that is reasonable to take. Consideration of other issues associated with any element that is linked to an ethical view has been considered as unacceptable as it brings in personal views that alter potential returns and investment risks.

Arguably this old definition is too narrow and no longer reflects broad societal norms and behaviours of scheme stakeholders of today. The "prudent person" today needs to act more responsibly by having regard to the impact of the fund investments and undertake active stewardship of the investments to maximise their long term return. In turn, this reflects a shift from the approach of attempting to 'do no harm' in managing monies held in trust, towards a contemporary challenge to 'ensure good is done', without financial detriment, wherever practical. Thus it is argued that it is in the interests of all stakeholders (including communities and government) to facilitate an environment in which pension funds increase their engagement with RI whilst maintaining the centrality of not harming their long term financial interests.

1.8 Of course many funds remain cautious in taking a more active approach to RI reflected in the continuingly negative investment advice received from advisors, based on limited knowledge and understanding of the issues.

2. Consultation Questions:

Question 1 How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

Changes to Develop More Responsible Investing

2.1 In LAPFF's view, laws and regulations need increasingly to reflect the reasonable views of communities and organisations of their time. In respect of pension funds and those responsible for looking after monies that benefit someone else (fiduciaries), the new consensus that has emerged has moved on from that of only a few years ago, reflecting the reaction to the recent 2008/2009 financial crisis and the many scandals attaching to poor corporate behaviour and performance of portfolio investments. We conclude that pension funds should not now have to *opt into* considering RI factors, as presently required by regulations, but *be required to address* such issues as part of their routine investment processes.

2.2 We conclude therefore that regulations could be amended to:

1. Require funds to have a policy concerning Responsible Investment factors and publish how this policy is applied to their investment processes.
2. Require funds to understand and monitor the RI impacts arising from their investment activity.
3. Demonstrate how they have been appropriately advised by relevant RI expertise, and
4. Require funds to disclose the actions they take to promote RI activity in their investment strategies and how they have also used their influence and worked with other investors.

2.3 These new requirements would be embedded in funds' investment processes, including the development of an investment strategy, appointment of advisors and asset managers, management of investments held and the transparent reporting of their policies, actions and outcomes. This would be taken to mean that RI would over time become an embedded approach in investment processes involving the integration of environmental, social and governance concerns at all levels.

Question 2 Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation? If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?

Stewardship

2.4 LAPFF does agree that the OPS investment regulations should be amended to require that all schemes should be required to adhere to the principles of the UK Stewardship Code.

2.5 However we also recognise that there remain weaknesses to the current Code, in particular its enforcement on a comply-or-explain basis and meaningful reporting and disclosure requirements under the terms of the Code. LAPFF will seek to set out its concerns in these areas and potential solutions, as part of the next proposed consultation on the Code by the Financial Reporting Council at the appropriate time.

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