

Response to the Consultation Questions

(Note the following abbreviations are used - S of S is Secretary of State, IS is Investment Strategy, RI is Responsible Investing and is interchangeable with ESG or Environmental, Social and Governance matters relating to investments)

1. Consultation Question 1

1.1. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation whilst still ensuring that authorities' investments are made prudently and having taken advice?

1.2. Response

Insert into regulations:

1. The S of S will produce guidance on the structure and broad content of the IS based upon advice received from a working group of practitioners and investment experts appointed by the S of S. The guidance will be issued following consultation with affected bodies and interested parties. The guidance will be reviewed and updated on a regular basis.
2. A fund will produce a public annual report covering the implementation of its IS and the performance outcomes of its investments. The report will be reviewed by a fund's appointed auditor with a requirement for the auditor to report to the S of S any concerns, reviewed by the fund's Local Pension Board, published on the fund website and presented at the fund's annual meeting.
3. Funds are required to:
 - a) Have a policy concerning RI factors and publish how this policy is applied to their investment processes.
 - b) Analyse and monitor the RI impacts arising from their RI policy on fund investment activity.
 - c) Demonstrate they have been appropriately advised by relevant RI expertise.

- d) 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.
- e) Demonstrate compliance with the principles of the UK Stewardship Code.
- f) Produce an annual report on RI activity.

1.3. Comments on Response:

- a) Guidance and ensuring the regulations are free from misinterpretation.
 - The proposed regulations state the IS should be formulated in accordance with S of S guidance, but fail to indicate the depth of this guidance or how it will be formulated. To overcome this problem it would be helpful if the regulations were clear on what and how guidance on the IS would be formulated and maintained. It is proposed to insert a clause detailing how the S of S will compile the advice by using an expert panel and a process of consultation.
 - Crucially a number of critical words and phrases in the proposed new regulations need some definition because of their potential for wide interpretation, which could lead to a lack of accountability and therefore increased risk where fund governance may be weak. In particular the following need some definition in order to prevent interpretations of the regulations that produce weak accountability or at the other end of the scale excessive accountability leading to poor VFM: examples are 'suitability', 'pooling', 'risk', and to 'consult such persons'. Appropriate definitions could be produced as part of the work of the S of S appointed expert panel.
- b) Balancing new freedoms with increased accountability.
 - The proposed regulations allow a fund to develop its own investment control limits which have to be set out in the fund's IS. In view of the importance of the IS and the need for enhanced accountability following the new freedoms, it would be appropriate to require funds to demonstrate good levels of accountability when exercising the new freedoms. Greater freedoms should be counter balanced by enhanced accountability through the IS. As currently specified in the new Regulation 7 it is not possible to identify how the establishment of that greater accountability might work in practice because of the lack of detail in the regulation clauses. It is proposed that this increased accountability is addressed through having a requirement to produce an annual report on the implementation of a funds IS which is distributed amongst interested parties.
- c) Responsible investing and consideration of ESG issues
 - Proposed regulation 7(e) refers to a fund having a policy on how social, environmental and governance matters are taken into account in the investment process. This unfortunately gives a fund the option of not identifying such matters to be part of its investment

strategy which is against the principles of good stewardship and protection of fund assets. It is clear LGPS funds have the power to engage with the responsible investment 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 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 assets.

- 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, and the risk/return ratio of, an individual investment or a 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 returns. They may nevertheless raise 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. In other circumstances RI factors have direct impact on investment returns where poor corporate practices undermine company performance through dysfunctional boardroom behaviour, fraud or customer abuse.
- 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
- 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 'minus RI'), on individuals and communities. Some would go further and wish to see 'their funds' used proactively to improve RI outcomes as an integral part of the investment strategy pursued.
- 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. 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. The pooling of assets will result in funds being identified as major shareholders with the expectation they act as such on governance and RI matters in general as many currently do individually as well as through LAPFF.

- 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 that impact on the performance of portfolio investments. Pension funds should not now have to opt in to considering RI factors, as presently required by regulations, but be required to address such issues as part of their routine investment processes. These new requirements would be embedded holistically throughout funds' investment processes, including the development of investment strategy; appointment of advisors and asset managers, and through pooling arrangements; 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 approach involving the integration of environmental, social and governance concerns at all levels.
- In addition, despite continuing weaknesses of the verification and implementation of the current Stewardship Code, in particular its enforcement of a comply-or-explain basis and meaningful reporting and disclosure requirements, all funds should sign up to the principles of the Stewardship Code.
- Further support for the positive approach to RI activity by pension funds can be found in the Joint Working Group of Local Authorities Report – Findings of Project Pool January 2016.

2. Consultation Question 2

2.1. Are there any specific issues that should be reinstated? Please explain why.

2.2. Response

a) No

3. Consultation Question 3

3.1. Is six months the appropriate period for the transitional arrangements to remain in place?

3.2. Response

a) Yes

4. Consultation Question 4

4.1. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?

4.2. Response

a) The regulations should specify that derivatives and other complex financial products should only be used where pension committee members have: received appropriate technical training to be able to understand the derivative product; have taken independent expert advice; and have received a report that indicates the worst case position for the fund.

4.3. Comments on Response

a) The suggestion that the regulation should include provision for derivatives to only be used as a risk management tool is a weak definition and could be subject to wide interpretation making their use over or under cautious. A major problem is defining derivative. This is because it covers many activities and can be defined in a number of ways, but can be broadly described as:

- Financial contracts whose value is derived from a traditional security such as an equity or bond, index or commodity and which are traded as speculative investments (buying and selling a contract at a particular time to make a profit) or to reduce risk of an exposure to a particular asset (e.g. a baking company might buy wheat futures to help manage its future costs).
- Contracts in this context are financial products such as future contracts, options, swaps, mortgage backed securities, etc. Derivatives are traded on exchanges or over the counter.
- Derivatives can be characterised by high leverage.

b) Having regard to the definition problems it is proposed that use of such products is controlled through requirements to ensure that those making the decisions over use of such products have relevant knowledge and understanding, take appropriate expert advice and have considered the potential worst case position.

5. Consultation Question 5

5.1. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?

5.2. Response

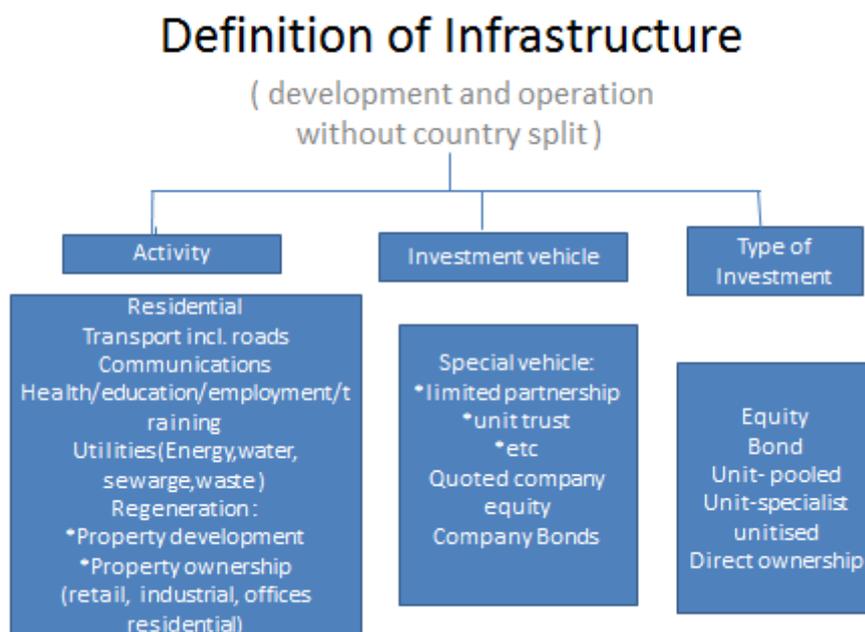
- a) Intervention should be limited to poor governance and significant administrative failings by a fund.
- b) Regulations 8(3) and 8(5) should be clear on the hierarchy of intervention detailed in the regulations:
 - S of S formally writes to fund detailing concerns and evidence leading to the correspondence requesting a reply within a fixed time period.
 - S of S considers response and if not satisfied requests further information or appoints an appropriate independent expert to investigate and prepare a report.
 - S of S, if not satisfied and if holds further action is required, details the failings and acceptable corrective action needed allowing a reasonable period of time for the fund to address and correct the failings before undertaking intervention by a third party.
- c) In respect of governance and significant administrative failings, regulation 8(4)) should be clear that the trigger for intervention is based upon evidence of failings as indicated by one or more of the following:
 - Adverse auditors report
 - Adverse report from Pension Regulator
 - Adverse report by actuary
 - Adverse reports from pension ombudsman or exceptionally high number of cases where the fund has failed
 - Report from Pensions Board
 - Indication the pension committee members and supporting officers and advisors do not have the relevant skills and knowledge
 - Substantially poorer returns relative to other funds over a rolling 3 to 5 year period
 - Employer contributions substantial higher than other funds and lower funding levels

5.3. Complaints from whistle blowers. Comments on Response

- a) The proposal for intervention covers two broad areas:
 - Poor governance and administrative failings; and
 - Failure by a fund to pool investments or invest as directed by the S of S
- b) It is understandable for the S of S to have the power to intervene to correct poor governance and significant administrative failings. However, this should not be extended to include intervention to make pension funds invest in specific assets or in a particular way based upon the views of the

S of S who is not directly responsible for individual fund investment outcomes.

- c) Intervention to direct funds' to pool and make certain investments goes against the statutory role of administering authorities and exceeds the intentions of the original statute governing the scheme made in 2013. These original regulations never envisaged the S of S directing funds to invest in a particular way or in a particular asset.
- d) Pension funds have recognised the VFM case for working together and there is sufficient evidence that funds are working towards pooling their investments in a way that will meet Government objectives. Funds do not currently need to be threatened with intervention to achieve the objective. It is also inappropriate to direct funds to make certain investments. If such action is taken, does the S of S become responsible for the performance of the assets funds are directed to invest in, and making good any shortfall compared with alternative opportunities?
- e) In directing funds to invest in a specific asset the problem of definition arises making the process of intervention challenging because it needs a definitive description to be workable. This is particularly the case with infrastructure and illustrated in the diagram below which highlights the elements that need to be considered in producing a robust workable definition.



- f) Regulation 8(2) should be limited to only applying to governance or significant administrative failings.

6. Consultation Question 6

- 6.1. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?
- 6.2. Response
 - a) See response to Question 5

7. Consultation Question 7

- 7.1. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?
- 7.2. Response
 - a) See response to Question 5

8. Consultation Question 8

- 8.1. Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority it is has not had regard to best practice, guidance or regulation?
- 8.2. Response
 - a) The objectives of proportionate intervention will not be realised. See response to Question 5 for details.