

Pension Fund Committee

Meeting to be held on 28 November 2014

Electoral Division affected: None

Outcome of the Socially Responsible Investment working group

Appendices 'A' and 'B' refer

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Executive Summary

At its March 2014 meeting, the Pension Fund Committee requested that a Working Group be established to consider any issues and make recommendations to the Committee on the social and environmental impacts of the Fund's investment strategy and activity. The Working Group was asked to report to the Committee in Autumn 2014.

The Working Group met on three occasions and discussed a wide range of issues relating to Socially Responsible Investment/ Environmental, Social, and Governance areas. These focussed on requirements arising from the Committee's fiduciary duty to beneficiaries and recent studies in this area, as well as examining the activities currently undertaken by the Fund in this area, and proposals for further activity.

An action plan has been developed to progress the recommended actions, which is attached as Appendix B.

Recommendation

The Committee is requested to consider the report and proposals of the Socially Responsible Investment Working Group and to determine future direction in this area.

Background and Advice

At its meeting on 27 March 2014, the Pension Fund Committee considered a report on proposals to commission advice in relation to various issues relating to the broader social and environmental impacts of the Pension Fund's investment activities.

The proposal was in response to the Notice of Motion carried by Full Council on 12 December 2013. The Notice of Motion asked officers to undertake work aimed at examining potential routes to increase the level of environmental and social responsibility of invested

companies and to examine the barriers to a policy of active divestment in areas which would appear to be in conflict with the County Council's broader policy agenda. It was suggested that the Committee establish a small task and finish group to review the scope of the project and to undertake the work. The task and finish group would aim to report back in autumn 2014.

The Socially Responsible Investment working group was subsequently established, and comprised the following members of the Committee:

- County Councillor M Parkinson - Chair;
- County Councillor M Brindle;
- County Councillor G Dowding;
- County Councillor D Westley;
- Councillor R Whittle, Blackburn with Darwen Borough Council.

The Group met on 23 July 2014, 9 September 2014, and 20 October 2014.

Summary of matters discussed and related outcomes

The following areas formed the main areas of debate:

- Fiduciary duty;
- Existing investment activity;
- Governance and policy;
- Analysis and monitoring.

Fiduciary duty

The attention of the Working Group was drawn to a Counsel's opinion secured by the LGPS Shadow Advisory Board and in particular the view that "The administering authority's power of investment must be exercised for investment purposes, and not for any wider purposes. Investment decisions must be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the fund (balancing risk and return in the normal way)". The opinion added that "So long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. In taking account of any such considerations, the administering authority may not prefer its own interests to those of other scheme employers, and should not seek to impose its particular views where those would not be widely shared by scheme employers and members."

The Working Group noted the Law Commission's view that trustees should take account of financially material risks and that non-financial factors may also be taken into account subject to the following two tests being 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.

The Law Commission also advised that trustees may not impose their own ethical views on their beneficiaries

There was also a discussion on the implications of this advice and the Working Group welcomed the clarification which the Law Commission and Counsel's Opinion had given to the role and duties of trustees when setting an investment strategy.

Outcomes:

- 1. Having considered all the information presented to its meetings, the Working Group agreed that it would wish to recommend the Pension Fund Committee to consider a more active stance in relation to responsible investment issues than had previously been the case where that did not pose the risk of financial detriment to the Fund. Members acknowledged that the primary aim of an investment strategy was to secure the best possible return and that the administering authority and trustees should not impose their own ethical views on issues such as tobacco, energy, food etc., on scheme beneficiaries.**
- 2. Concerns were expressed about the Fund's ability to canvass and assess the views of scheme employers and members on specific social, ethical and environmental considerations and investments. Before taking any specific steps that could potentially lead to the investment in or disinvestment from particular sectors, Members acknowledged that it was important to canvass and understand the views of scheme stakeholders, and agreed that different ways of achieving this needed to be explored.**
- 3. The Working Group felt that it now had a much greater understanding of SRI and ESG issues and in particular the legal framework around fiduciary duties and the issue of disinvestment. Members again acknowledged that the primary aim of the Fund's investment strategy was to secure the best possible return and it was agreed that disinvestment was not an option which should be pursued by the Fund at this moment.**

This enhanced understanding has led to a recognition of definitional differences between 'responsible investment (RI)' and 'socially responsible investment'. Outcome 3 above demonstrates that the Fund is seeking to pursue an RI approach rather than a SRI approach, as defined by the National Association of Pension Funds (NAPF):

Responsible Investment is an investment approach in which investors recognise the importance of the long-term health and stability of the market as a whole; seeking to incorporate material extra-financial factors alongside other financial performance and strategic assessments within investment decisions; and utilise ownership rights and responsibilities attached to assets to protect and enhance shareholder value over the long term – primarily through voting and engagement.

SRI is defined as an investment approach that combines investment returns with moral or ethical roles that are not generally driven by financial considerations. It involves the exclusion of so-called 'sin stocks' regardless of their financial performance, but also seeking to achieve social and environmental objectives. The outcomes above demonstrate the Working Group's view that such an approach is not desirable or appropriate for the Fund.

Accordingly, the term 'responsible investment' (rather than socially responsible investment) will subsequently be used in this report to refer to the investment approach.

Existing investment activity

The Working Group reviewed the Fund's current investments in the context of ESG considerations. While there were a significant range, particularly of clean energy investments of various types officer emphasised the fact that these investments had been identified based on the Fund's desire to have a diverse investment portfolio but more importantly the anticipated long term financial return. Social, ethical and environmental considerations had not played any part in the decision making and the Working Group noted that this reflected how the primary consideration of securing the best possible return was linked to investments which could be considered "ethical" or "socially responsible".

Outcome:

- 4. The Working Group encouraged the taking of specific steps or actions to reduce carbon production within the Fund's portfolio - for example, within the property portfolio. In addition, the Group supported the continued identification of good investment opportunities and the making of investments that provide appropriate returns and which may possess certain 'green' or clean energy characteristics.**

Governance and policy

There was a discussion around the Environment Agency's move towards environmental investments which had achieved a return above benchmark. It was suggested that the Fund should look at best practice models of RI including the EA's investment strategy. The EA and several other Funds had also signed up to the UN-backed Principles for Responsible Investment and it was felt that the Lancashire County Pension Fund should also work towards the adoption of the UN's principles:

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress towards implementing the Principles.

Details were discussed of the approach undertaken by the Environment Agency, which was arguably the most advanced LGPS fund in terms of developing a responsible investing approach. In addition, the responses of 19 members of the CIPFA Pensions Network to questions around ethical investment policies were circulated and discussed.

In order to promote accountability through transparency, the Group felt that more could be done to set out the Fund's beliefs in this area and by doing so sending an explicit message as to the seriousness of its intent. In this context adopting an external standard such as the UN Principles would provide a basis for measuring progress.

Outcome:

5. The Working Group recommend the adoption by the Fund of a Responsible Investment Policy based on the Policy Tool produced by UNPRI, and subsequently work towards the adoption of the UN Principles.

It was felt that the advice and guidance of the Law Commission and Counsel's opinion gave the Pension Fund Committee a degree of flexibility to consider its own position and the direction of travel it might wish to adopt in respect of responsible investment. Any moves towards responsible investment would need to be embedded in the Fund's statement of investment principles (SIP), investment strategy, asset allocation, fund manager selection and performance monitoring.

The current version of the Fund's Statement of Investment Principles, approved by the Pension Fund Committee in March 2014, contains the following paragraphs relating to ESG issues:

Social, Environmental and Ethical Considerations

The Fund takes an active stance on corporate governance issues. It uses Pensions Investment Research Consultants ("PIRC") to vote on its behalf at shareholder meetings. PIRC advises on Socially Responsible Investment issues and issues voting guidance and commentary for shareholder meetings. PIRC is instructed to vote the Fund's shares in accordance with its guidelines

unless an Investment Manager requests a different vote for investment management reasons. In the latter case, the Treasurer to the Fund will decide how best to cast the vote in the long-term financial interest of the Fund.

The Fund is a member of the Local Authority Pension Fund Forum (“LAPFF”), which is a group of like-minded local authority pension funds that meet to discuss and act / engage in respect of Socially Responsible Investment and Corporate Governance issues.

6. A proposal for revised responsible investment wording within the SIP should be produced.

In advance of revised wording arising from the development of a Responsible Investment policy, proposed wording to enhance the Fund's stance in this area is attached as Appendix A for consideration.

In terms of influence and engagement, the Group agreed that the influencing of behaviour relating to ESG considerations through LAPFF and PIRC continued to be important. It was noted that LAPFF would welcome the opportunity to engage more effectively with members of the Committee including the attendance of members at its meetings. The Group welcomed the prospect of senior representatives of both LAPFF and PIRC being scheduled to present to the November 2014 meeting of the Committee, and to hear what both organisations do on the Fund's behalf and what more could be done to increase engagement.

Analysis and monitoring

In wishing to be a good asset owner, and promote transparency and accountability – the adoption of an analysis tool or model (such as those developed by Northern Trust and Robeco) to measure carbon footprints and risks, and/or environmental, social and governance (ESG) issues across the Fund's portfolio was discussed.

Whilst not advocating a move away from unconstrained equity mandates, the Group felt that ESG issues should form a more structured element of the ongoing discussions that the Fund has with its external managers. Such discussions may be helped, but not dependent upon, the procurement of an appropriate monitoring tool.

Outcomes:

- 7. Investigate the options for procuring/ signing up to an ESG monitoring tool/ service.**
- 8. Formalise ESG discussions with external investment managers as part of ongoing engagement.**

Consultations

N/A

Implications:

This item has the following implications, as indicated:

Risk management

No significant risks have been identified in relation to this report.

Local Government (Access to Information) Act 1985 List of Background Papers

Paper	Date	Contact/Directorate/Tel
Report to the SRI Working Group – 9 September 2014	September 2014	Andrew Fox/ County Treasurer's Directorate/ 01772 535916
National Association of Pension Funds (NAPF) Responsible Investment Guide	2013	Andrew Fox/ County Treasurer's Directorate/ 01772 535916

Reason for inclusion in Part II, if appropriate

N/A

Corporate Governance and Responsible Investment

Corporate Governance

The Fund recognises its responsibility as an institutional investor to support and encourage good corporate governance practices in the companies in which it invests. The Fund considers that good corporate governance can contribute to business prosperity by encouraging accountability between boards, shareholders and other stakeholders. Good corporate governance also plays a major role in encouraging corporate responsibility to shareholders, employees and wider society.

The Fund's approach to Corporate Governance

The Fund has a longstanding policy of supporting good corporate governance in the companies in which it invests, and challenging companies who do not meet the standards or reasonable expectations set by their peers.

In order to fulfil this responsibility, the Fund communicates with companies and exercises the rights (including the voting rights) attaching to investments in support of its corporate governance policies. The Fund's voting rights are an asset and will be used to further the long-term interests of the Fund's beneficiaries. As a general principle, votes will be used to protect shareholder rights, to minimise risk to companies from corporate governance failure, to enhance long-term value and to encourage corporate social responsibility.

The Fund may utilise some or all of the following tools: writing to company management; special meetings with companies; questions and discussions with companies at routine meetings and AGMs; joining in or supporting campaigning or pressure groups; issuing public statements/ briefings; and proxy voting.

Responsible Investment

Responsible Investment is an investment approach in which investors recognise the importance of the long-term health and stability of the market as a whole; seeking to incorporate material extra-financial factors alongside other financial performance and strategic assessments within investment decisions; and utilise ownership rights and responsibilities attached to assets to protect and enhance shareholder value over the long term – primarily through voting and engagement. The objective of responsible investment is decreasing investor risk and improving risk-adjusted returns.

Examples of potentially material risks to be considered as part of the Fund's voting and engagement activity are set out below:

Governance risks:

- Board independence – Non-Executive Directors play a vital role in overseeing the executive management and safeguarding the interests of shareholders;
- Succession planning – An ineffective policy can have implications for a company's performance, including uncertainty over its sustainability;
- Board diversity – Research suggests that shareholders, companies and boards are not best served by an overly homogenous board prone to group think;
- Auditors – The independence of auditors plays a crucial role in protecting shareholders.

Environmental risks:

- High intensity industries will incur additional financial costs from carbon regulations in different jurisdictions. Changes in climate will affect company supply chains and fixed assets;
- Energy use – Through effective management of energy use, companies are able to reduce energy costs as well as build security of supply;
- Natural resources – Demand for raw materials is ever increasing, this has implications including increasing regulation around sourcing and use of resources;
- Water – A growing global population is leading to rising consumption – this in turn increases costs and creates tensions or conflicts.

Social risks:

- Human rights – Companies operating in companies with poor human rights records may face significant challenges, such as legal challenges or reputational damage;
- Employment – Research indicates that well managed employee relations improve worker productivity and effectiveness in turn benefitting shareholders;
- Health and safety – Companies with poor health and safety records may face prosecutions, fines and in extreme cases, the withdrawal of licences to operate;
- Supply chain – Companies are increasingly reliant on a large, global workforce, exposing them to increased risks of disruptions.

Implementing a responsible investment policy helps a pension fund to adhere to the UK Stewardship Code. The Fund's current position relating to the UK Stewardship Code can be found in a separate statement on its website.

Lack of good governance interferes with a company's ability to function effectively and is a threat to the Fund's financial interest in that company.

The Fund's approach to responsible investment

The Fund's approach to responsible investment divides into four areas of activity.

a) Voting Globally

The first approach, voting, is certainly not a 'box-ticking' exercise, as the Fund regularly votes against resolutions. The Fund, through a proactive voting policy, in partnership with PIRC, votes its share rights constructively based upon a comprehensive analysis of company voting issues.

PIRC is instructed to vote the Fund's shares in accordance with its guidelines unless an Investment Manager requests a different vote for investment management reasons. In the latter case, the Treasurer to the Fund will decide how best to cast the vote in the long-term financial interest of the Fund.

b) Engagement through Partnerships

The Fund's second approach involves working in partnership with like-minded bodies. The Fund recognises that to gain the attention of companies in addressing governance concerns, it needs to join other investors with similar concerns. It does this through:

- Local Authority Pension Fund Forum (LAPFF);
- Voting on shareholder resolutions;
- Joining appropriate lobbying activities.

In terms of its engagement approach with other investors, it is most significant through LAPFF. This Forum exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social

responsibility and high standards of corporate governance among the companies in which they invest. See the LAPFF website for further details: www.lapfforum.org

c) Shareholder Litigation

The third approach, adopted by the Fund in order to encourage corporate management to behave responsibly and honestly, is through shareholder litigation. The Fund, in partnership with two US law firms and other shareholders, submits class actions globally where possible and where appropriate.

d) Active Investing

The fourth and most challenging activity for the Fund in this particular field is actively seeking investments with ESG characteristics, provided these meet the Fund's requirements of strong returns combined with best practice in ESG and/or corporate governance. Such investments include alternative energy, clean energy, shared ownership housing.

The Fund will continue to develop its approach in promoting effective corporate governance and socially responsible investment wherever possible, including working towards certain recognised standards in order to increase transparency and accountability.

Proposed Action Plan arising from RI Working Group

Area	Option	Resources	Direct Cost £	Timescale	Ease to achieve	Priority
Fiduciary duty						
<p>Outcome 1 Having considered all the information presented to its meetings, the Working Group agreed that it would wish to recommend the Pension Fund Committee to consider a more active stance in relation to RI issues than had previously been the case where that did not pose the risk of financial detriment to the Fund. Members acknowledged that the primary aim of an investment strategy was to secure the best possible return and that the administering authority and trustees should not impose their own ethical views on issues such as tobacco, energy, food etc., on scheme beneficiaries.</p>						
Action 1	Recommendation to Pension Fund Committee to consider a move towards RI where it was practicable to do so, and without posing a detrimental financial risk to the Fund.	Officer time	None	Subsequent meeting of the Pension Fund Committee	Easy	High
<p>Outcome 2 Concerns were expressed about the Fund's ability to canvass and assess the views of scheme employers and members on specific social, ethical and environmental considerations and investments. Before taking any specific steps that could potentially lead to the investment in or disinvestment from particular sectors, Members acknowledged that it was important to canvass and understand the views of scheme stakeholders, and agreed that different ways of achieving this needed to be explored.</p>						
Action 2	A policy setting out the circumstances in which stakeholder consultation would be sought and the possible methods for achieving this should be developed.	Officer time	None	31 December 2014	Moderate	Low
<p>Outcome 3 The Working Group felt that it now had a much greater understanding of RI, SRI and ESG issues and in particular the legal framework around fiduciary duties and the issue of disinvestment. Members again acknowledged that the primary aim of the Fund's investment strategy was to secure the best possible return and it was agreed that disinvestment was not an option which should be pursued by the Fund at this moment.</p>						
Action 3	None.					
Existing investment activity						
<p>Outcome 4 The Working Group encouraged the taking of specific steps or actions to reduce carbon production within the Fund's portfolio - for example, within the property portfolio. In addition, the Group supported the continued identification of good investment opportunities and the making of investments that provide appropriate returns and which may possess certain 'green' or clean energy characteristics.</p>						
Action 4	Reduce carbon footprint of LCPF property portfolio wherever possible	Specification/ procurement/ installation	Dependent on options	Ongoing	Difficult	Medium

Area	Option	Resources	Direct Cost £	Timescale	Ease to achieve	Priority
Governance and policy						
Outcome 5 The Working Group recommend the establishment by the Fund of a Responsible Investment Policy based on the Policy Tool produced by UNPRI, and subsequently work towards the adoption of the UN Principles.						
Action 5a	Create a Responsible Investment Policy for the Fund	Officer time	None	By 31 December 2014	Easy	High
Action 5b	Consider signing up to the UN PRI initiative	Officer time Ongoing compliance	£5,640 p.a.	Sign up by 31 March 2015	Sign-up – easy Monitoring - moderate	Medium
Outcome 6 A proposal for revised SRI wording within the SIP should be produced.						
Action 6	Rewrite Statement of Investment Principles section on RI/ ESG	Officer time	None	Immediate – proposal attached as Appendix B	Easy	High
Analysis and monitoring						
Outcome 7 Investigate the options for procuring/ signing up to an SRI/ ESG monitoring tool/ service.						
Action 7	Procure/ sign up to RI/ ESG monitoring tool/ service eg RobecoSAM	Officer time	Details awaited	By 31 March 2015	Moderate	Medium
Outcome 8 Formalise SRI/ ESG discussions with external investment managers as part of ongoing engagement.						
Action 8	Create structured framework for ongoing discussions with external investment managers.	Officer time	None	By 31 December 2014	Easy	Medium