Investment, Governance and Engagement Sub Committee

Item 6 – Paper B

Responsible investment guidance

The Board agreed in March 2017 that the Investment, Governance and Engagement committee should commission work to prepare a working draft of guidance on responsible investment for their consideration at the meeting on the 26th June.

Brian Bailey (PIRC) and Dawn Turner (Environment Agency) were invited to prepare a first working draft for consideration by the committee.

A copy of the draft guidance is at **Annex 1.**

Recommendation – that the committee considers the draft guidance and agrees that comments on the draft should be submitted to the Pensions Secretary by Friday the 16th June.

Annex 1

Guidance on Responsible Investment and Engagement 5
Local Government Pension Scheme
DCLG Guidance on Preparing and Maintaining an Investment Strategy Statement September 2016
Draft of Additional Guidance Material

This is additional guidance to that circulated by DCLG in September 2016 in association with the introduction of the LGPS (Management and Investment of Funds) Regulation 2016.

The following are the features of an ESG (social, environmental and governance) policy that an AA (Administering Authority) is required to produce in respect of Regulation 7e):

Appropriate Advice / Maintenance of relevant Skills and knowledge

1. In formulating its approach in compliance with the 2016 Regulations an AA will need to ensure it takes proper advice and can demonstrate it is acting reasonably in meeting its long term fiduciary duties and responsibilities

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having regard to the financial impact on its investment risk calculations and forecasts. An AA should ensure the range of ESG advice they need to meet their policy objectives is available as required for policy development, monitoring and reporting on ESG matters. Skills and knowledge requirements for members, officers and other committee or panel members need to be demonstrated and maintained in respect of ESG matters. This is particularly critical in the context of newly created LGPS pooling arrangements

Range of ESG Issues

2. An AA must have a policy on the three elements referred to in the regulations: - environmental, social and corporate governance matters. ESG issues are wide ranging and include:

Environmental – • Pollution • Resource management e.g. water, waste, minerals • Carbon Footprint Assessment and carbon management • Renewable energy/energy efficiency • Emissions management relative to comparable organisations and government expectations
Social • Human capital management and employment standards • Impact investing • Child Labour • Health and safety • Fair tax contributions • Employee representation • Community relationships • Supply chain management • Equality
Governance • Quoted Company and other investor bodies' governance compliance with best practice e.g. structure of the board, executive pay, reliable accounts, board diversity • Treatment of shareholders (or investors) and alignment with their long-term interests • Governance risk relative to other investments • Exercise of asset ownership rights e.g. proxy voting, company engagement, litigation for failures by management • Capital market reform to enhance long term investing objectives

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An AA will need to articulate its process for identifying the issues that are considered relevant to it and their priority for consideration and action. Priorities could reflect the extent of any financial impact (risk and return) on their fund's investments, or the significance of an issue with local communities. Concerns could be with an individual company or a wider ranging systemic risk. Investors face several systemic risks with climate change being a good example impacting on sectors, industries, and geographical location. Many impacts are negative, but some are positive such as for green energy potential investment opportunities. Large diversified investors will find it difficult to avoid systemic risks completely and need to develop policies that manage the risks over the short and long term.

Any approach an AA develops and then adopts formally, as required by the 2016 Regulations, will need to be dynamic and responsive. Priorities will change due to issues developing or materially significant matters emerging over short to medium time frames . Officers and advisers will have important ongoing monitoring and compliance roles to fulfil.

Selection and Management of Assets

3. The ESG policy of an AA needs to indicate how ESG issues will be considered in the selection, non-selection, retention and realisation of investments. This should connect to the AAs assessment of the suitability of investments (Regulation 7 d)) and the AAs approach to risk measurement and management (regulation 7 c)). Also, ESG issues need to feature in the ongoing governance of an AA's interest in the assets held. It should be clear ESG factors are being taken into account where they are, or may be, financially material.

Application to Asset Classes

4. The ESG policy will need to provide a comprehensive coverage of all asset classes used or considered for use by the AA. Authorities invest in a very wide range of assets and whilst pooling should produce some simplification and reduction in the number of managers investing funds on behalf of AAs, an ESG policy will still need to cover a wide range of asset classes. Asset classes used and for which an ESG policy is required include:

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Equities • Pooled Global • UK • Pooled overseas • North America • Europe – Excluding UK • Japan • Asia Pacific – Excluding Japan • Emerging	Alternatives • Private equity • Hedge funds • Infrastructure • Active currency • GTAA • Commodities Property • Pooled Global • UK • Overseas
Bonds • Pooled • Conventional UK – gilts and corporate • Conventional Overseas • Inflation linked UK • Inflation linked Overseas	Cash Currency Hedging Pooled Multi-Asset Positive ESG investing

Each Authorities ESG policy will need to cover the diverse range of assets held by type (equities, bonds, property) and reflect its rights as owners through the investment vehicle (quoted company, partnership, units, insurance policies). The ESG policy will also need to reflect geographical, regional and country variations.

A comprehensive ESG policy and strategy will require significantly more than the historic focus on quoted equities. However, the task should be eased by the a number of asset classes now having ESG evaluations as part of the asset due diligence process prior to investing e.g. private equity, infrastructure, property .

An AA may take time to fully develop its ESG policy effectively to all asset classes. Such an approach should be set out in an AA's ESG policy statement with a relevant time line,responsibility indicators, and a plan for full i implementation. A full monitoring and review strategy should also be regularly provided.

Depth and Extent of Governance Activity

5. An AA has options as to the how and the extent it will consider and address ESG matters. Three approaches are outlined below to illustrate the range of responses open on a spectrum of options. This shows at (a) option level 1 an AA meeting core regulatory expectations, (b) option level 2 illustrates an AA determining to have a higher level of engagement and more

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extensive fund views on ESG matters, and (c)option level 3 which has an AA with a broad active engagement approach directly controlled by its AA members. Here an AA is demonstrating a high conviction to ensuring its ownership rights maximise their impact on ESG issues and concerns. They will have dedicated resources allocated for ESG policy implication and development directly controlled and managed by the AA.

Option Level 1

The AA is principally concerned with ensuring that it meets expected legislative standards. This makes sure there is strategy in place, a coherent proxy voting policy and some form of engagement by asset managers. A passive contributor to joint working with other funds nationally with a major emphasis on Governance issues.

It is possible in terms of meeting the LGPS regulatory requirements to have a broad ESG strategy which puts the onus on asset managers supervised by the pool operator to operationalise such a strategy with regular monitoring reports on activity undertaken. This represents a minimum option. An AA can develop a high-level perspective, leaving the pool operator and asset managers to develop the strategy and operationalise it. The impact will be a responsive approach to issues when concerns get raised and an indirect access by the AA to managers who are responsible for the management of ESG matters within a fund's high level policy. Involvement in controversial or high profile issues are likely to be avoided.

Option Level 2

Under Option 2 AAs will go further than Option 1 and develop a more fund-specific approach to some ESG activities such as voting activity and join other lead funds on some company engagement concerns. The AA will expect increased accountability from asset managers on ESG matters and purposeful engagement particularly on high profile issues. There is increased governance activity in this option and an AA will take an active interest in a limited range of environmental and social issues.

Option Level 3

In this option an AA seeks a proactive approach to addressing a wide range of ESG issues with a strategic perspective. An AA will integrate their ESG activity into their overall investment strategy, actively engage with companies, understand the governance risk in their portfolios and seek to actively manage that risk. They are likely to have significant dedicated resources allocated to achieving their ESG objectives. The AA would want to be responsive to issues and have direct control over engagement on ESG matters.

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The AA objectives would be detailed and based upon a comprehensive strategy that is operationalised as far as practical by the AA itself giving it much greater flexibility to respond to ESG matters it considers as important. It would make greater use of expert advice and provide a dedicated resource to managing and implementing its ESG policy and priorities. It may use a separate agent to oversee and implement its strategy and ongoing determinations where specialist capabilities are not available at the AA itself. In addition, it will assess its capability in responding to capital market developments to contribute to long term investing opportunities and removing barriers.

This approach requires the responsibilities that come with operating a pool to be appropriately arranged to ensure an AA’s wishes are implemented. The AA and the Pool Oversight Body in a pooling arrangement cannot undertake any executive investment management functions. However, there is nothing to prevent a pool operator being required to respond to and facilitate the implementation of AA guidance on how ESG matters should be addressed in its share of the assets invested. Also, the Pool Operator could be required to facilitate a fund’s ESG agent in proxy voting and company engagement.

ESG Policy Operational Arrangements

6. An AA will need to establish suitable fund specific operational arrangements to facilitate the implementation of its ESG policy. The key operational issues an AA will need to consider are:
   - Resource levels to allocate to managing its ESG policy and approach,
   - Accountability and reporting lines to ensure its policies and decisions are implemented and the outcomes are reported in a comprehensive and transparent manner to all interested parties
   - Determination of where to source ESG material and advice to formulate and monitor its ESG policy and its operational impact
   - Management of company engagement activity, voting arrangements, membership of ESG groups (e.g. LAPFF, UNPRI, IIGCC), and securities litigation
   - Consultation process with interested parties on formulation of the ESG strategy and regular reporting of the outcomes.
   - Determination of any AA elected member supporting bodies to reflect extent and depth of ESG policy such as ESG sub-committee.
   - Monitoring arrangements for the implementation of its ESG policy including regular reviews of its policies and strategies.

Pooling Arrangements - Role of Pool and investment managers in supporting and facilitating an AA policy

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7. Requirements on a pool operator and managers to support individual AA ESG policy implementation should be clear in the relationships established by the commissioning AA and its fellow pool subscribers. Some AAs may wish to delegate specific elements of its ESG policy implementation to its pool operator and managers whilst at all times retaining ownership and responsibility for ESG policy. Others may want to be in more direct control of the implementation of their policy requiring a facilitation role from its pool operator and managers. Pooling arrangements will need to be established that give a clear line of sight for an AA to its share of assets in the pool. In order to exercise ownership rights over the underlying investment an AA will need to be clear its requirements on ESG are accepted, understood and facilitated by the pool operator and any asset manager appointed by the pool. The pooling arrangements should require an asset manager to comply with AAs collective and potential individual stewardship requirements, particularly in respect of voting and engagement issues. Pools should use their scale to ensure an AA's wishes are fully implemented or consider excluding managers who cannot meet the defined needs. Arrangements to ensure orderly adjustments to the ESG policy framework will also need to be agreed, monitored, adjusted and maintained.

Working with other Investors

8. The closer AAs work together on ESG matters the more effective and efficient they become in delivering on their objectives. AAs are encouraged to find similar ground and work together in using their influence to promote good governance of assets in which they invest. It becomes increasingly important to form investor coalitions around capital market reform programmes to enhance long term investing cultures and other strategic objectives to protect assets and enhance investment value and returns.

Stewardship Code and other Good Practice Organisations

9. The UK Stewardship Code is recognised as an effective standard for asset owners and asset managers to comply with and demonstrate best practice in discharging their stewardship responsibilities. AAs should adopt the Stewardship Code as part of their ESG policy and require all appropriate parties engaged in managing their assets to also adopt the code. There are a number of membership organisations that have international coverage with the objective of promoting and demonstrating best practice in discharging ESG responsibilities. An AA should regularly review their commitment to such organisations as part of the process of formulating their

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ESG policy and its maintenance. Examples of organisations are LAPFF, UNPRI, IIGCC.

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