Agenda Item

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Environmental, Social and Governance (ESG) Policy Review

Agenda Item 6

Falkirk Council

Title:	**Environmental, Social and Governance Policy Review**
Meeting:	**Joint Meeting of Pensions Committee and Pension Board**
Date:	**8 December 2016**
Submitted By:	**Director of Corporate and Housing Services**

1. Purpose of Report

1.1 The analysis of a company's Environmental, Social and Governance (ESG) activity is increasingly considered an appropriate way to assess investment risk, complimenting, as it does, the more traditional focus on financial return.

1.2 This report provides Committee and Board with:

- details of the legal considerations surrounding ESG policy;
- details of the Fund's existing ESG Policy; and
- a summary of the themes emerging from the Fund's recent ESG seminar.

1.3 The report also contains options for developing the policy and is intended as a basis for further discussion.

2. Recommendations

2.1 The Pensions Committee and Pension Board are asked to consider the options set out in this report for updating Fund policy on ESG matters.

2.2 The Pensions Committee is asked to confirm:

a) which of the report options, if any, it wishes to take forward;
b) whether there are any other options it wishes to consider in terms of developing Fund ESG policy;
c) whether the proposed course of action should be consulted upon more widely with stakeholders (i.e. Trades Unions and Employers).

2.3 The Pensions Committee invites the Chief Finance Officer to bring forward revised ESG proposals to the March Committee and Board with a view to the revised ESG Policy being incorporated within the Statement of Investment Principles.

3. Background

3.1 ESG describes a group of risks that are relevant to investors in their decision making process. These risks include a company's approach to environmental stewardship, corporate governance and social policy.

3.2 The Falkirk's Fund approach to ESG matters was set a number of years ago and, following work undertaken by the investment sub group earlier this year, it was agreed that consideration would be given to updating the Fund's approach.

3.3 The Fund hosted a seminar on 24th October which looked at ESG from a variety of perspectives – Investment Managers, LGPS Funds, Investment Adviser and Environmentalists.

3.4 The event was attended by representatives of Fund Employers, Trade Unions as well as by members of the Pensions Committee and Pension Board.

3.5 Speakers covered a range of topics including

- the legal obligations within the scheme rules
- the nature of fiduciary duty
- the significance of ESG as an investment risk
- the case for sustainability as a component of Fund investment policy
- the case for divestment from companies with high carbon emissions
- the case for engagement rather than divestment
- the way Fund managers manage ESG risks and incorporate them into investment decision making
- the ESG metrics that are available

3.6 A copy of the seminar slides has been placed in the Objective Connect folder for this quarterly meeting, together with a copy of the current Statement of Investment Principles.

4. Legal Considerations

4.1 LGPS rules require Funds to maintain a written Statement of Investment Principles (the "SIP") specifying the extent to which social, environmental or ethical considerations are taken into account in selecting and retaining investments.

4.2 The rules also require that, in determining investment policy, proper advice is taken and that the policy is formulated having regard to:

- investing in a "wide variety of investments", and
- the suitability of particular investments

4.3 In addition to the regulatory position, Fund "trustees" (i.e. the Pensions Committee) owe a fiduciary duty to Fund stakeholders (i.e. beneficiaries and employers) to act selflessly, responsibly and with prudence on behalf of stakeholder interests, putting aside their own personal views and interests.

4.4 The consensus view of fiduciary duty, based on case law and legal opinion, is that the interests of stakeholders are best served by trustees pursuing the maximum financial returns for an acceptable level of risk. Given that ESG risks can affect financial returns, it is entirely appropriate and consistent with fiduciary obligations that such risks are considered by Fund "trustees".

4.5 Whilst ESG matters may be considered by trustees in terms of the risks they pose to the Fund, it has to be borne in mind that the legal purpose of the Fund is to provide benefits for members. The Fund's approach to investment must therefore be consistent with this legal purpose and not be in pursuit of any other purely ethical aim.

4.6 The most recent legal opinions would suggest that

- trustees should invest in a wide variety of suitable investments;
- trustees should pursue the best financial position for the Fund (balancing risk and return);
- the precise choice of investment can be influenced by wider social, ethical or environmental considerations, so long as that is not to the material financial detriment of the Fund.
- trustees should not impose their particular views unless they know these to be shared widely by employers and beneficiaries.

4.7 The constraints outlined in paragraph 4.6 means that trustees could reasonably update their ESG policy to reduce carbon exposure recognising that increased global temperature and related regulatory action is likely to pose a risk to the returns from underlying investments. By contrast, a policy to exclude, for example, tobacco stocks would be harder to justify since the aim in that instance would be to improve health rather than protecting Fund returns.

5. Current Fund ESG Policy

5.1 The Fund's current approach to ESG is described in Section 10 of the Statement of Investment Principles. This acknowledges the Fund's obligations as a responsible investor and its commitment to monitoring investee companies to ensure they meet standards of acceptable corporate practice.

5.2 The policy states that the Fund's focus will be in the areas of:

- Corporate environmental policy
- Human Rights
- Employment Standards (incl Executive pay)

The Committee will need to consider whether to retain its focus on these elements or give greater weight to other matters, such as the threats from climate change.

5.3 Engagement and influence on these matters takes place through the Fund:

- having regular discussions with its Managers;
- exercising voting rights through proxy voting agents; and
- being a member of the Local Authority Pension Funds Forum.

5.4 In terms of whether to continue to engage with or disinvest from recalcitrant companies, Fund practice is to rely on the expertise of Managers to make such decisions on a risk versus return basis.

6. Seminar Themes

Climate Change Risks

6.1 A major part of the Fund's ESG Seminar was devoted to climate change risk, including the risks associated with:

- Supply chain disruption
- Stranded assets
- Increased government intervention and regulation (e.g. COP21 agreement)
- Transition to a lower carbon economy
- Competitive environment triggered by the drive for cleaner technology

6.2 The Fund Managers who addressed the seminar all indicated that a key part of their investment process was to understand how companies were tackling climate change risk within their business models.

Sustainability

6.3 The seminar heard a plea from Terry A'hearn, Chief Executive of SEPA for the Fund to put sustainability at the heart of its decision making processes, arguing that environment pressures would drive change and, as a result, traditional investment parameters would no longer be appropriate.

Divestment v Engagement

6.4 A spokesperson for Friends of the Earth cited the need to accelerate action in the face of climate change and argued that disinvestment was needed since engagement without a finite deadline appeared to be ineffectual.

6.5 Counter arguments were made by several speakers:

i) Outright divestment would mean underweighting the energy sector and potentially missing out on exposure to newer, cleaner, technologies as fossil fuel companies adapt their business models to a low carbon environment

ii) Outright divestment would mean losing any opportunity to influence a company in relation to their carbon emissions

iii) Fund Managers, the spokespersons for the Lothian and Strathclyde Funds, and the LAPFF all supported a policy of ongoing engagement, citing the importance of maintaining some influence with corporates

iv) Fund managers were paid handsome fees to assess all risks, including climate change risk, and should therefore be trusted, to source the best risk adjusted investments for their respective portfolios. This included knowing when to switch away from carbon intensive stocks. (e.g. Newton have significantly reduced their fossil fuel exposure in recent years)

Stranded Assets

6.6 The seminar heard from Carbon Tracker an independent think tank which undertakes research on the impact of carbon risk on financial markets, particularly fossil fuel companies. Their spokesman advised that many oil and gas companies were putting investors' capital at risk by continuing to pursue a "business as usual" growth model in the face of falling demand for fossil fuels.

6.7 Carbon Tracker advised that investors should challenge companies on their oil price assumptions to ensure that their capital expenditure programmes were consistent with the assumptions. They also considered that investors should only have exposure to energy companies with modest capital programmes as this was consistent with the attempt to limit temperature increases to 2 degrees and did not require such a high oil price to generate profits.

Carbon Measurement

6.8 Some of the Falkirk's Fund's Managers were more successful than others in providing data about carbon exposure within their portfolios with the best responses from Schroder and Baillie Gifford. The Schroder response indicated that the majority of carbon emitting assets related to a small percentage of the portfolio. However, the variability of response from Managers suggested there was a need for a more consistent approach taken to measuring carbon emissions across the Fund.

6.9 Research showed that financial institutions appeared to be bringing a variety of low carbon investment vehicles to market (e.g. Schroders Global Climate Change Fund) along with various indices against which to benchmark performance (e.g. MSCI Global Low Carbon Index family).

7. Options for Developing Policy

7.1 The following actions could be considered as a means of further developing the Fund's ESG policy:

- The Fund has adopted the following investment belief relating to ESG.

  "Environmental, social and corporate governance ('ESG') issues can have a material impact on the long term performance of its investments - the Committee recognises that ESG issues can impact the Fund's returns and the Committee aims to be aware of, and monitor, financially material ESG-related risks and issues through the Fund's investment managers. The Committee commits to an ongoing development of its ESG policy to ensure it reflects latest industry developments and regulations."

  The Committee may wish to review this statement to ensure that it continues to express their aspirations and aims in relation to ESG matters.

- Monitor the Fund's carbon exposure on an annual basis using third party specialists in order to better understand the associated risks. This would provide both consistency of measurement across mandates and provide a benchmark against which further actions can be considered.

- Confirm that, in line with the strong comments made by advisors and other LGPS Funds, a policy of engagement is preferable to complete disinvestment.

- Engage to a greater extent with Managers regarding their underlying exposure to fossil fuel companies and carbon risk. Build a constructive dialogue to better understand the current approach to the management of these risks and allow more effective challenge by the Committee.

- Adopt the United Nations Principles of Responsible Investment (UNPRI) and the UK Stewardship Code (see Appendix 1 for obligations). The annual fee for joining is around £3,000. It should be noted that recent regulatory change has effectively made it mandatory for LGPS funds in England and Wales to become signatories to the Stewardship Code.

- Report quarterly to Committee and Board on Voting undertaken by PIRC and consider publishing these details.

- Ensure that in any new manager search, the manager's ability to deliver sustainable long term growth is a priority.

- Make an initial allocation (e.g. up to 5% of Fund) to a fund which tracks a low carbon index or has sustainability and long term returns at its core.

7.2 A representative of the Fund's Investment Advisers, Hymans Robertson, will be attending the meeting and will be able to provide further insight into possible courses of action.

7.3 It is noted that the European Parliament has just passed the IORP (Institutions for Occupational Retirement Provision) II Directive which contains legal requirements for Schemes to take ESG risks into account into investment decision making processes. Member states will have two years in which to transpose the requirements into domestic law. It remains to be seen whether the UK Government proceeds with this in the light of the Brexit vote.

8. Implications

Financial

8.1 Recommendations taken forward from this report may impact on the investment returns of the pension fund and by extension on the contribution rates payable by employers. There is a cost of around £3k p.a. in becoming a UNPRI signatory.

Resources

8.2 Some recommendations (e.g. greater reporting of voting and manager engagement, ongoing monitoring of the Fund's carbon exposure) will result in an administrative overhead and would require an allocation of constrained staff time.

Legal

8.3 Recommendations taken forward will require to comply with the terms of the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 and with the principles of fiduciary duty.

Risk

8.4 Failure to implement the proposal could lead to the Fund being accused of taking insufficient notice of ESG risks, such as climate change, and potentially failing in its fiduciary duty.

Equalities

8.5 There are no equality issues arising from the proposals.

Sustainability/Environmental Impact

8.6 The subject matter of this report includes the risk to the Pension Fund from climate change. Depending on the recommendations taken forward, there may be scope to reduce the Fund's carbon risk exposure.

9. Conclusions

9.1 The Pensions Committee has agreed to review the Fund's approach to ESG activities. The area of greatest interest is likely to be around the Fund's response to the challenges of climate change. Having heard from a variety of specialists at the recently convened ESG seminar, a range of options have been presented in this report for further consideration by the Committee and Board.

9.2 It is anticipated that following discussion a further iteration of the ESG proposals will be presented to the Spring meeting of the Committee and Board.

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Appendices

Appendix 1 – Implications for Signatories of UNIPRI and UK Stewardship Code

List of Background Papers:

- None

Appendix 1

United Nations Principles for Responsible Investment

Commitment

"As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time).

We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

Six Principles

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.**"**

UK Stewardship Code

The Stewardship Code is a set of seven principles released in 2010 by the Financial Reporting Council directed at institutional investors who hold voting rights in United Kingdom companies.

The Code sets out a number of areas of good practice to which the FRC believes institutional investors should aspire. The FRC encourages all institutional investors to publish a statement on their website of the extent to which they have complied with the Code, to notify the FRC when they have done so and whenever the statement is updated. The FRC also encourages each institution to name in its statement an individual who can be contacted for further information and by those interested in collective engagement.

1. Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.
3. Institutional investors should monitor their investee companies
4. Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.
5. Institutional investors should be willing to act collectively with other investors where appropriate.
6. Institutional investors should have a clear policy on voting and disclosure of voting activity.
7. Institutional investors should report periodically on their stewardship and voting activities.

Pensions Section

23 November 2016