The DWP's consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'.

Response by the Environment Agency Pension Fund

Important notice
The document is a response to the DWP's consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'.

The response to this consultation is undertaken on behalf the Pension Committee and in consultation with the administering authority Environment Agency. Any questions should be sent to dawn.turner@environment-agency.gov.uk.

FAO: REINVIGORATING.PENSIONS@DWP.GSI.GOV.UK

Dear Sirs,

We welcome the opportunity to respond to DWP's consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'.

The Environment Agency Pension Active Fund (EAPF) is a defined benefit Local Authority Government Pension Scheme with over 23,000 members and assets of £2.4 billion. It provides for the future pensions of its members working for Natural Resources Wales, Shared Services Connected Limited and Environment Agency. There is a 95 per cent participating rate of eligible members.

Our fiduciary duty is to act in the best long-term interest of our members and to do so, requires us to recognise that environmental, social and governance (ESG) issues can adversely impact on the Fund's financial performance and should be taken into account in the funding and investment strategies and throughout the funding and investment decision making process.

Further details are contained in our responsible investment policy, and managers are expected to comply with this policy when complying with this Statement of Investment Principles.

A summary of our key Responsible Investment (RI) principles;

- Apply long-term thinking to deliver long-term sustainable returns.
- Seek sustainable returns from well governed and sustainable assets.
- Apply a robust approach to effective stewardship.
- Responsible investment is core in our skills, knowledge and advice.
- Seek to innovate, demonstrate and promote RI leadership and ESG best practice.
- Apply evidenced based decision making in the implementation of RI.
- Achieve improvements in ESG through effective partnerships that have robust oversight.
- Share ideas and best practice to achieve wider and more valuable RI and ESG outcomes.
- Be transparent and accountable in all we do and in those in which we invest.

We welcomed the Law Commission's report on the fiduciary duties of investment intermediaries and in particular the Trustee guidance "Is it all about the money?". The guidance is a valuable resource which we have used in Trustee training and wider industry engagement. In particular we believe it has helped in clarifying an area of law that has been the source of much confusion and concern amongst Trustees, officers and other intermediaries.

We particularly welcomed the clarification in the report that material environmental, social and governance risks are financial risks and should be considered in investment decision making.

We recommend Trustees should state their policies in relation:

- to directly or indirectly evaluating longer-term risks, including from environmental, social or governance (ESG) and other factors, which may become financially material to the performance of their investments

- to the extent (if at all) to which they may consider making investment decisions on the basis of non-financial factors.
- How the fund either directly approaches its stewardship responsibilities or oversees how stewardships activities are applied by external fund managers across all asset classes and in all markets in which the scheme invests.

In relation to the UK Stewardship Code, we recommend there be a requirement on Trustees to state in their SIP:

- that they have signed up to the Stewardship Code, or explain why they considered this was not relevant to them in discharging their investment duties; and
- if they have signed up to the Code, how they comply with the principles of the Code, or explain to what extent, and on what grounds their approach departs from these principles.

We would also recommend the inclusion of a requirement for an annual implementation statement should be included in the annual report and financial statements.

We would recommend that, in addition to the clarification to the investment regulations themselves, the DWP build on the work of the Law Commission and include comprehensive guidance in the explanatory notes. These notes would set out what is expected of Trustees with respect to the effective implementation of fiduciary duty, including the requirement to have received training based on the work of the Law Commission and DWP with respect of Fiduciary duty over the next 12-18 months, which in itself be a huge step forward.

We answer the specific questions raised in the consultation below and would welcome a further conversation with the DWP as its thinking develops in this area.

Yours sincerely

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Consultation questions

Legal Context - Local Government Pension Scheme (LGPS) investment management

The Environment Agency Pension Fund (EAPF) has responded to this consultation from the Department of Work and Pensions (DWP) 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 (LGPS) investment management regulations, currently in place.

The investment activities of the Fund are undertaken in accordance with the relevant regulations and legal opinions published on the interpretation of the law. The position for the Fund is set out in the relevant Investment Management Regulations specifically for the Scheme[1]. 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 "social, environmental or ethical considerations" in their Statement of Investment Principles (SIP), even if they intend taking no action. They are also required to take advice on investment matters.

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…"

The EAPF is pleased with the recent clarification by the Law Commission that material environmental, social, or governance ("ESG") factors that pose risks to the long term sustainability of a company are classified as financial factors. By extension, this means that financially material ESG issues should be taken into account by Trustees (or those acting as Trustees as in the case of the LGPS) as part of their fiduciary duty. It is now clear that many ESG 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.

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[1] The Local Government Scheme (Management and Investment of Funds) Regulations 2009

The debate surrounding the LGPS regulations has reached similar conclusions[2] with the additional

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?

Vagueness and misuse of terminology has undermined the ability of Trustees to consider, with confidence, a broader spectrum of risks, particularly long term risks, within funding and investment decision making. We believe that clarifying the distinction between financial and non-financial factors is important, but needs very careful consideration as it is often the motivation in the consideration of the factor, rather than the factor itself, that determines whether it is financial or non-financial. The Law Commission itself, eloquently illustrate this in their guidance looking at the issue of tobacco.

We believe, strongly, that strict labelling of certain types of factors as “financial” and others as “non-financial” would be very unhelpful and rapidly become outdated. We believe the guidance should focus on the process of evaluation, discussion and judgement behind the integration of a wide-range of factors in investment decision-making.

We were delighted with the unambiguous message from the Law Commission that material environmental, social, or governance (“ESG”) factors that pose risks to the long term sustainability of company are classified as financial factors. Guidance and support is needed to help Trustees in the consideration of these factors, when it is not always possible to be quantitative and or where these risks might materialise over a longer time horizon.

The Law Commission and DWP should therefore make sure that there is no misconception: if ESG factors can influence long-term value and if engagement with companies can help to reduce long-term risk and increase value, then Trustees overall have a fiduciary obligation to take ESG factors into account and disclose how they are doing so. We recommend Trustees should state their policies in relation:

- to directly or indirectly evaluating longer-term risks, including from environmental, social or governance (ESG) and other factors, which may become financially material to the performance of their investments
- to the extent (if at all) to which they may consider making investment decisions on the basis of non-financial factors.
- How the fund either directly approaches its stewardship responsibilities or oversees how stewardships activities are applied by external fund managers across all asset classes and in all markets in which the scheme invests.

We are of the view that Trustees should take these issues into account where material rather than, as the consultation suggests, being able to decide whether to take them into account or not. We believe this was the tone and intent of the Law Commission’s own view.

[2] http://www.lgpsboard.org/images/PDF/Publications/QCOpinionApril2014

Clear communications to the beneficiaries about how their Trustees consider such risks in their funding and investment processes, including exercise of stewardship activities, are essential. We believe that such transparency extends beyond principles and policy statements and also recommend the inclusion of a requirement for an annual implementation statement should be included in the annual report and financial statements.

To support this process, we recommend the Government / DWP needs to mandate Trustees receive training based on the work of the Law Commission and DWP with respect of Fiduciary duty over the next 12-18 months. Furthermore, Trustees need to keep knowledge up to date and the supporting notes directs Trustees to where they may seek, often at no cost, information to support them in this decision making. Sources include the Principles for Responsible Investment, UKSIF, ShareAction, Intuitional Investor Group on Climate Change, to name but a few.

While Trustees might find it difficult to assess ESG factors and then make the right decisions taking these factors into account, there is an increasing body of evidence to demonstrate not only that they have a bearing on financial performance but that some activities, including active stewardship, can positively influence long-term risk adjusted returns. In our view this is best implemented by a combination of integration of ESG factors as part of the investment process and through active stewardship of portfolio companies and assets.

We would also encourage the DWP to promote the value of asset owners working in collaboration, which is very different from 'acting in concert', the misconception of which has also hindered some Trustees. The importance and impact of asset owners sending a consistent aligned signal to the market as to what it expects of various investment actors (investment managers, companies, consultants etc) on ESG related matters should not be underestimated. An example of this is the recently launched **Guide to Responsible Investment in Public Equity[3]** – an important investor coalition effort of which the Fund was a deputy editor and key participant.

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?

We do think there is a case for clarifying and in some cases strengthening the duty of investment intermediaries to their clients, but sympathise with the previously stated position of the Law Commission that "any attempt to change fiduciary duty through legislation would result in new uncertainties and could have unintended consequences".

However, it is important to provide greater certainty on the interpretation of the general law of fiduciary duties such that these are consistent with the aim of promoting behaviours aligned to pension funds' long-term investment horizons.

There are two issues with the use of the Stewardship Code as an appropriate way to implement the Law Commission's recommendation.

[3]http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0424_guide_to_responsible_investment_reporting_in_public_equity_published.aspx

1. The currently Stewardship Code is not current structured or worded to make it directly applicable to pension Trustees or pension funds.
2. Stewardship is both broader than the consideration of ESG factors and is only one component of the consideration of ESG factors in investment decision making.

These point are explored in more detail below.

The EAPF were one of the first signatories of the UK Stewardship codes and remains one the few asset owner signatories. Our compliance statement https://www.eapf.org.uk/en/investments/stewardship .

1. <u>The currently Stewardship Code is not current structured or worded to make it directly applicable to pension Trustees or pension funds</u>

Anecdotal feedback suggests of many asset owners do not see any applicability of the Stewardship Code to them, but as something their asset managers do. This observation is supported by the low level of asset owner signatories, particularly ones who outsource asset management and engagement.

We believe all asset owners should be compelled to consider the Stewardship Code as part of determining their own responsible ownership. However, unless amended to encompass the requirements of pension fund Trustees as asset owners, it is not appropriate, or indeed helpful, to require compliance as it will not address the issues raised in the Law Commission's report.

Many funds, like the EAPF, delegate stewardship activities to their asset managers or specialist provider. In our view, without also demonstrating robust oversight, monitoring and reporting, then an asset owner who delegates such activities, is not complying with the spirit of the code. As the Stewardship Code is currently set out it could be too easy and meaningless for asset owners to claim compliance and still not addressing their fiduciary duty as defined by the Law Commission.

2. <u>Stewardship is both broader than the consideration of ESG factors and is only one component of the consideration of ESG factors in investment decision making.</u>

We reiterate the point that vagueness and misuse of terminology has undermined the ability of Trustees to consider, with confidence, a broader spectrum of risks, particularly long term risks, within funding and investment decision making. One example of such terminology is the missuse of the term "stewardship". Thus it is crucial in any guidance that the DWP or other relevant body produces that whilst "stewardship" and "Responsible Investment /ESG" overlap, they are not to be conflated.

Stewardship is engagement with companies, fund managers or other investment actors as a tool to enhance risk-adjusted returns. Engagement activities may include monitoring and engaging with said investment actors on matters such as culture, strategy, performance, risk, capital structure, ESG issues and alleged violations of securities laws (shareholder litigation). It is important that Trustees understand where these concepts overlap, but also as important, where they differ. Stewardship is much broader than voting and company engagement on ESG issues and similarly consideration of ESG factors in investment decision making is broader than Stewardship.

<u>Recommended amendments to the fund's Statement of Investment Principles ("SIP")</u>

The Law Commission previously recommended that Trustees should be encouraged to consider whether and how to carry out their stewardship responsibilities – engagement with investee companies and exercising of voting rights - either directly or through their investment managers. The report recommended including a specific requirement for the fund's Statement of Investment Principles ("SIP") to contain a statement of the Trustees' policy (if any) on stewardship.

In the Government's response to the Law Commission's report it committed to consulting on changes to the Investment Regulations to require Trustees to state their policy (if any) on stewardship in the SIP, suggesting this should mirror what is set out in the current principles and guidance requiring Trustees to report against the Stewardship Code and we are broadly supportive of such an approach.

The effect of this it is suggested would be a requirement on Trustees to state in their SIP:

- that they have signed up to the Stewardship Code, or explain why they considered this was not relevant to them in discharging their investment duties; and
- if they have signed up to the Code, how they comply with the principles of the Code, or explain to what extent, and on what grounds their approach departs from these principles.

In order to tackle both the second question and the second concern raised above, we are very supportive of updating the current language as suggested by requiring Trustees include a statement within the SIP of their policy in relation:

- to directly or indirectly evaluating longer-term risks, including from environmental, social or governance (ESG) and other factors, which may become financially material to the performance of their investments
- to the extent (if at all) to which they may consider making investment decisions on the basis of non-financial factors.
- How the fund either directly approaches its stewardship responsibilities or oversees how stewardships activities are applied by external fund managers across all asset classes and in all markets in which the scheme invests.

While adopting a strict "comply or explain" requirement for Trustees to describe their efforts to comply with the explicit requirements of the Stewardship Code as recommended by the Law Commission may not currently be the most effective course- all asset owners should have flexibility to "explain" their approach to the key points described above.

Question 3- What steps would Trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2? What, if any, costs would be involved in meeting any new requirements?

There are no costs to Trustees in considering how ESG factors might be incorporated into their funds' decision making process and how stewardship activities could be undertaken. The current framework that the Trustees currently operate under should be sufficient. In addition, there are a number of organisations as well as other asset owners who would be prepared to support Trustees in this consideration at no or very little cost.

The costs only have the potential to be incurred during implementation; the level depends on the approach taken. In practice, this can take several different forms from developing a specialised in-house resource to deploy the fund's ESG integration and stewardship work, to outsourcing these responsibilities to third party service providers on a full time basis, to simply retaining the services of consultants on an ad-hoc basis.

The first step we would recommend to any asset owner Trustee, is to enquire what their Asset manager/s (AM's) are already doing. What ESG risk analysis does their AM's investment process already include?, How does this work? What is the AM's approach to stewardship e.g. voting? In other words, turn the compliance statements of the Stewardship code in questions to ask managers. This action will incur little or no cost. The approach of the EAPF is to undertake our stewardship activities via our managers. We have directly asked and all our managers ensure us that in undertaking and reporting on ESG risks and Stewardship occurs at no additional cost to us as clients. This best achieved through building these requirements into manager selection and contractual documentation such as investment manager agreements.

We chose to undertake enhanced engagement on our index funds through a specialist provider and do have some in-house resource to assist with investment strategy design and implementation e.g. monitoring managers but also wider industry engagement. We undertake this additional work as we believe it adds both the reputation of the fund but also enhances the long term returns of the fund.

Further information

We are open and transparent in how we invest and what we invest in, and there is a wealth of information available at **www.eapf.org.uk** where you will also find our Annual Report and Financial Statements.