MUNICIPAL YEAR 2019/2020 REPORT NO. 91

Agenda – Part:2	Item: 9
Subject: Integrating ESG considerations within the Pension Fund Investment Strategy	
Wards:	
Key Decision No:	
Cabinet Member consulted:	

MEETING TITLE AND DATE:
Pension Investment & Policy Committee
5th September 2019

REPORT OF:
Director of Finance

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1. EXECUTIVE SUMMARY

i) This paper details a broad approach to support Committee decision-making on investment decisions that takes into account ESG concerns.

ii) The paper recommends that the Committee chooses to move a portion of the passive equity allocation to a low-carbon equivalent, the precise portion of which is to be delegated to the Director of Finance

iii) The paper discusses how the ESG concerns could be incorporated within the Investment Allocation Strategy of the Pension Fund and to use the window of opportunity of the Triennial Review to support that process.

2. RECOMMENDATIONS

The Pension Policy & investment Committee (PPIC) recommends

i. Using the survey of its membership on ESG issues, commissioned in a prior paper to support the Triennial Review process

ii. That officers conduct a thorough review of all its investments in a holistic manner at the same time it reviews its investment allocation at the Triennial review

iii. That the Fund switches some or all the passive equity mandates into a low carbon target index fund, the precise amount of which is delegated to the Director of Finance and the Chair of the PPIC

iv. That the Fund works with other Funds within the London CIV to shape the choice of the sub-funds available to ensure it has investment options available with the appropriate risk-adjusted return that take into account the ESG considerations raised by members of the Pension Fund.

v. That officers bring back a draft plan to the PPIC, with timescales on it that reviews the entire Fund and also its investment allocation.

vi. That the Fund considers how its investment portfolio could be de-carbonised, subject to appropriate available investments, and consult with other forward-thinking Pension Funds, such as Islington and Brunel, to find examples of good practice.

3. BACKGROUND

3.1 The Pension Fund is required to achieve the best possible risk adjusted return that it can reasonably achieve. However, it is also allowed to take into accounts ESG (Ethical, Social, Governance) issues, especially, as these issues may represent large risks to that same risk-adjusted return.

3.2 It is important to recognise that there are costs to moving out of investments that may or may not meet ESG concerns and these costs can be as a little as a few basis points (BPs) on the investment to percentages (0.03% on a £100m being £30k to 2% on a similar investment being £2m). It all depends on the original investment terms and conditions. Moving into investments can also be quite expensive, depending on the type of investment.

3.3 Equally, conducting a fire sale can mean moving out of investments that have a 15 or 25-year horizon, which in the case of private equity can mean selling at a significant discount (20% or more potentially).

3.4 Finally, it is worth noting that if the Fund was to have a lower return due to excessive costs, this will feed through into contribution rates, affecting both the Council and other employers. Other employers within the Pension Fund would not wish to fund poor performance and might seek legal action.

3.5 Inevitably, Pension Funds have long-term horizons, as they aim to afford the pension payments to members that may still be coming out of the Fund 75 years from now. In such a long-term horizon, there is a very strong focus on the investment allocation, which gets reviewed in detail every 3 years. Investment allocation, contribution rates and individual investment returns are the pillars upon which overall Fund performance rests.

3.6 There has been a need to review the Fund's structure for a significant period of time, as it has approximately twice the number of sub-funds as typical Funds of a similar size. Therefore, there is an opportunity to restructure the fund and make a wider change in the individual investments gradually over the next few years to deliver **Portfolio De-Carbonisation**, as was discussed in the previous paper.

3.7 Nonetheless, this is not going to lead to an immediate change in all investments, as there need to be appropriate investments available. Government has mandated that investments are required to be procured through the relevant collective investment vehicle, wherever possible. This is because the economies of scale can and indeed have produced large savings to date for the Pension Fund.

3.8 Equally, over the next six months, the Pension Fund will be using the data from the Pension Fund Triennial valuation to develop the investment allocation.

3.9 Results from the ESG survey, commissioned by the Fund will come back to the Committee during this period. Members of the Pension Fund have already been advised through their Annual Benefit Letter that such a survey will be coming through to them.

3.10 The Pension Fund can use that window of time to review its entire portfolio, investment by investment, so that it not only understands the performance but the ESG implications to each investment.

3.11 The information developed by this work will allow the Pension Fund to determine what each investment building block should contain (number of investments and type). Member input will be supported by training that each member needs to complete. Similarly, officers will be refreshing their knowledge base on specific investment categories to ensure that they are able the decision-making process effectively.

3.12 This will support a measured approach to gradually re-allocate funds as and when appropriate over the coming years, when they do not meet the new investment allocation, without leading to discounted prices due to emergency sales.

3.13 It will also allow the Pension Fund to lobby the London CIV and work with fellow London boroughs for investment options where none currently exist.

Passive Equity

3.14 Some LGPS funds have converted some of their passive Equity funds to low carbon mandate and these portfolios are being managed by BlackRock and LGIM. Low carbon passive strategies are made available with reduced fee arrangements for LGPS funds.

3.15 Officers would work with the fund manager, investment adviser and investment consultant to identify a suitable approach to its passive mandates in an efficient cost-effective manner for the Fund with a view of implementing the appropriate strategy for the Fund in the current calendar year.

3.16 The tracking error for the low-carbon option is very low. Tracking error measures the difference between the performance of a fund and its benchmark.

3.17 Nonetheless, while it is in the list of the recommendations that some of the passive equity monies could be moved into a carbon-friendly option at low-risk, more research needs to be undertaken before the precise amount is determined for the immediate switch. The results of the Triennial Review and the Investment Allocation will support decisions over the remaining passive element.

4. ALTERNATIVE OPTIONS CONSIDERED

No alternative

5. REASONS FOR RECOMMENDATIONS

a) As per the previous report, the Pension Policy & investment Committee act in the role of trustees for the Pension Fund and are therefore responsible for the management of £1.16 billion worth of assets and for ensuring the effective and efficient running of the Pension Fund. The management of the Fund's investment portfolio and the investment returns that the Fund is able to deliver have significant financial implications, not just for the Fund itself but also on the Fund's employers in terms of the level of contributions they are required to make to meet the Fund's statutory pension obligations.

b) It is important that the Pension Fund undertakes decisions in a measured way, that links directly to Investment Strategy.

6. COMMENTS FROM OTHER DEPARTMENTS

6.1 Financial Implications

a) The current Investment Strategy has been implemented to maximise returns of Fund's assets within acceptable risk parameters and to facilitate a reduction in the burden of deficit funding for which employers in the Fund are liable.

b) The performance of the Fund's strategy is monitored through a quarterly report that is presented to the Committee. Recent performances have been good and generally either in line with or exceeded target.

c) The consideration to invest in Low Carbon strategy is to reduce the Enfield Pension Fund exposure to carbon investments.

6.2 Legal Implications

a) The Committee has legal responsibilities for the prudent and effective stewardship of the Pension Fund and a clear fiduciary duty in the performance of its functions. The LGPS (Management and Investment of Funds) Regulations 2016 require Administering Authorities to state the extent to which they comply with the Guidance given by the Secretary of State. In accordance with regulation 7(2)(e) the authority must set out in its Investment Strategy Statement, its policy on how social, environmental and corporate governance considerations are considered in the selection, non-selection, retention and realisation of investments.

b) Updated Statutory Guidance on preparing and maintaining an investment strategy statement was published on the 15th September 2016. Having a policy in place covering the authority's approach to ethical, social and governance issues will enable to authority to meet its statutory duties in this regard. The recommendations discussed in this report are in line with both the Committee's terms of reference and legal responsibilities.

7. KEY RISKS

a) The greatest risk to the Fund is in making overly quick decisions that lead to additional costs and potential legal challenges. It can reduce these by ensuring all members are trained, that it has a clear investment strategy.

b) As in the previous paper, in recognising the risks that climate change and stranded assets scenarios could pose to the Fund, the Committee needs to understand where these risks might apply and how they can best be mitigated within the investment management framework within which LGPS funds operate.

Background Papers
(To be email on request)

i) LAPFF Guidance on Fossil Fuel and Stranded Assets

Appendix 1: Islington Case Study