Full Council Guidance Note on Pension Fund decision making

This note sets out some background in relation to the East Sussex Pension Fund (ESPF) including its approach to Environmental, Social and Corporate Governance matters with respect to investment decisions. The note also sets out a summary of the duties of the Local Government Pension Scheme (LGPS) Administering Authorities and the Pension Committees to which authority for investment-decision making is delegated.

1. Key numbers for the East Sussex Pension Fund

1.1. The primary Fund objective is to provide pension and lump sum benefits for members on their retirement and/or benefits on death, before or after retirement, for their dependants, on a defined benefits basis. To provide such benefits, contributions have been made by members in the course of their employment of an employer which has been admitted to membership of the Fund, and as a result of this, it was found by the Supreme Court that members' pensions represent deferred pay, hence the assets invested by the Fund are those of the beneficiaries and not of any other stakeholder. These contributions are then invested by the Fund in order to provide the benefits to which members are entitled when they fall due. The assets of the Fund are kept legally separate from the assets of each participating employer (including the Administering Authority's) and are held for the specific purpose of providing retirement and death benefits to members and their beneficiaries.

1.2. The ESPF membership of **82,003 individuals** comprises:

a. 24,083 pensioners, who are receiving their pensions

b. 24,327 active members, who are in employment of one of the scheme employers and making monthly contributions to the Fund

c. 33,593 deferred members, who have previously made contributions to the Fund and have accrued benefits which will be payable on retirement, but who are not now contributors to the Fund.

1.3. There are **140 scheme employer** organisations, including East Sussex County Council, Brighton & Hove City Council, the five borough and district councils, academies, universities, colleges, public authorities and staff transferred to admitted bodies.

1.4. The Fund maintains a diverse range of **investments totalling £4.5bn** (31 December 2022) across different investment asset classes, geographies and sectors to manage risk and investment returns to meet current and future liabilities while keeping employer contribution rates stable.

1.5. As the decision-making body in relation to the investments of Fund assets, the Pension Committee is supported by a Pension Board and a number of experienced executive officers (including the Head of Pensions, Finance Manager for Investments and Accounting and the Council's Chief Finance Officer). The Pension Board and executive officers take responsibility for ensuring that advice is obtained from appropriately qualified and experienced external advisers so that the Pension Committee can comply with its legal and fiduciary duties to take advice before investing Fund assets in any manner.

2. <u>East Sussex Pension Fund approach to Environmental Social and Corporate Governance (ESG) matters in investment decisions</u>

2.1. The Fund's Investment Strategy Statement (ISS), includes a Statement on Responsible Investment Principles which was approved in September 2020. The ISS explains that the Fund believes that climate change poses material risks and sets out its position on climate change and the energy transition. This is updated annually and an annual implementation statement is published.

2.2. The Pension Committee believes that it should:

a. apply long-term thinking to deliver long-term sustainable returns;
b. seek sustainable returns from well-governed assets;
c. use an evidence-based long-term investment appraisal to inform decision-making in the implementation of responsible investment principles and consider the costs of responsible investment decisions consistent with its fiduciary duties; and
d. evaluate and manage carbon exposure in order to mitigate risks to the

Fund from climate change.

2.3. Exposure to fossil fuels within the total portfolio has been assessed at 1.3% (£58m) at 31 December 2022. There is no single definition of fossil fuel exposure and this figure includes utility companies (more than half of the exposure). Most definitions will be companies with more than 10% of their revenue linked to the following activities: exploration and extraction of fossil fuels; processing/refinement of oil; transport of fossil fuels; and essential and specific products or services for the exploration, extraction or processing of fossil fuels. Definitions can also relate to fossil fuel reserves held. The Fund's exposure to Oil and Gas Majors, as set out in the World Economic Forum list, is 0.4% (18.6m).

2.4. The Fund maintains a position of engagement/influence through investment managers and its collaborative work, rather than exclusion of sectors from the investment strategy. This is consistent with the approach which DLUHC expects the Fund (and all other LGPS Funds) to take – favouring engagement over divestment. This ensures the Fund is diversified and those companies working towards or helping the energy transition are not excluded. It also enables the Fund to exert influence over companies which the Fund considers (in light of its Responsible Investment Principles) need to take further or different action on ESG matters (including climate change). The Fund's strategy does allow for divestment of a specific company where engagement and escalation does not achieve a sufficient outcome.

2.5. Information on the Fund's equity voting and examples of engagement are published on a quarterly basis.

2.6. The Fund is a signatory to the 2020 UK Stewardship Code, a member of Local Authority Pension Fund Forum (LAPFF), a member of the United Nations established Principles of Responsible Investment (PRI), Pensions for Purpose and the Institutional Investor Group for Climate Change (IIGCC); these represent best practice, or are collaborative engagement groups for stronger influence through greater investor share.

2.7. In 2021, the Fund won the LAPF Investment award for LGPS Fund of the Year (over £2.5bn) and was highly commended for its climate strategy.

2.8. The Fund is directed by the Government to invest in an LGPS pool and the recent Budget announcement suggests a consultation will be issued shortly to require investment of all liquid assets through the pool by March 2025. The Fund is a member of the **ACCESS Pool** with 10 other Administering Authorities: Fund officers are actively involved in developing the pool's approach to ESG where RI guidelines have recently been approved by the Joint Committee and an ESG advisor will be procured to help drive a number of improvements at the pool level.

2.9. ESG and Climate Risk are both explicitly identified on the Risk Register for the Fund.

2.10. The Fund monitors the carbon emissions of the investment portfolio annually and reports on this in an annual report following the Taskforce for Climate Related Financial Disclosures (TCFD) guidance (even though LGPS Administering Authorities are not yet required to prepare and publish TCFD reports). Carbon emissions of the portfolio were 55% lower in 2022 compared to 2020.

2.11. ESG and climate risk matters are factored into Pension Board and Pension Committee discussions, Fund Manager meetings and all investment decision making.

2.12. A significant number of changes have been implemented since 2019 to reduce climate risk within the Fund reducing the fossil fuel exposure from the 4.2% identified to Full Council in October 2019 to the 1.3% in December 2022. The Fund has not only focused on climate risk but also climate opportunity, investing in investments that generate positive social or environmental impacts such as leading the transition by investing in renewable energy, electric vehicles, sustainable materials, pollution control or other growth sectors.

2.13. Training is regularly provided to the Pension Board and Pension Committee on ESG issues including Climate Change and Climate Risk.

2.14. **The Pension Committee has commissioned a project to assess the fiduciary and legal consequences of fossil fuel divestment for the Fund**; examine how such a move aligns with relevant guidance and advice; explore how practical an act it would be within the context of the government's pooling agenda; and review evidence on the efficacy of such an approach in promoting the energy transition. These are complex and developing issues which require a deep and practical understanding of the effect of global policy decisions on macro-economics and investment chains over varying time horizons. The outcomes from this project and research will be discussed at a strategy day in July and will help the Committee assess its approach to climate change and its investment decision making.

3. Duties of LGPS Administering Authorities

Fiduciary Duty

3.1. A "fiduciary" is a person or organisation who acts on behalf of another person or persons (the "beneficiaries") to **manage their assets** (or assets from which they are entitled to benefit). A fiduciary can therefore be an individual, a company or another body that has legal personality such as a public body. Essentially, a *fiduciary* owes to their beneficiaries the **duties of good faith and trust.** The primary object of any fiduciary duties in a pension scheme are the beneficiaries of that scheme. The fundamental legal principle of fiduciary duty applies in respect of the ESPF (and the LGPS as a whole) in the same way as it applies in respect of any other funded occupational pension scheme – and breach of this duty can have serious consequences. LGPS Administering Authorities are also subject to public law duties – and it is these duties (amongst other legal requirements) which necessitate the delegation of decision-making in relation to LGPS Funds by the Administering Authority to its Pension Committee (members of which are both fiduciaries and subject to public law duties).

3.2. One important aspect of being a fiduciary is that the law requires fiduciaries to be scrupulous about conflicts of interest and potential conflicts of interest whether, in each case, those conflicts are actual or perceived. The Pension Committee is subject to the statutory obligation to have political balance in their membership. Whilst all Pension Committee Members bring with them their own knowledge and experience, political views must form no part of the consideration of issues or of the decision-making process. Pension Committee members must act as fiduciaries, safeguarding the interests of those to whom they owe their duties – beneficiaries of the Fund. Committee Members must take decisions in accordance with their public law obligations, including the obligations of reasonableness, rationality and impartiality.

3.3. The Pension Fund is ring-fenced and represents separate assets from the general assets of the authority and which must be used for the sole purpose of paying pension benefits. When Committee Members are asked to make a decision on a matter affecting the Fund or its beneficiaries, they must always act as a fiduciary and must also keep in mind that the purpose behind ESCC having been given the statutory responsibility for administering the Fund is ultimately to pay pensions.

3.4. The members of the LGPS make contributions to the Scheme and their contributions are made in the course of doing their jobs. Members' pensions therefore represent deferred pay, just as the courts have regarded private sector pensions as deferred pay in cases going back as far as the early 1990s.

Case law on ethical investment has confirmed the following principles:

a. Subject to obeying the law, the duty of the fiduciaries (whether trustees of private sector occupational pension schemes or LGPS Pension Committees in respect of LGPS Funds) towards their beneficiaries is paramount. Fiduciaries should exercise their powers in the best interests of the present and future beneficiaries of the scheme.

b. When the purpose of the scheme (whether a trust established as the basis of a private sector occupational pension scheme or the statutory scheme under which the LGPS is constituted) is to provide financial benefits for the beneficiaries, the best interests of the beneficiaries are normally their best financial interests. It follows therefore that the fiduciaries' investment powers must be exercised so as to yield the best return for the beneficiaries, judged in relation to the risks of the investments in question.

c. Fiduciaries must put on one side their own personal interests and views when acting in their fiduciary capacity (for the benefit of others). If investments of any type would be more beneficial to the beneficiaries than other investments, the fiduciaries must not refrain from making the investments by reason of the personal views that they hold.

d. Benefit has a very wide meaning, and there are circumstances in which arrangements which work to the financial disadvantage of a beneficiary may overall be for his benefit when considered by reference to the expectations of all beneficiaries. Such cases are likely to be very rare, however, and investment on this basis is normally only permissible in the context of pension schemes (as distinct from charitable trusts) where the terms of the scheme in question expressly and directly permit investment decisions to be made on such a broad assessment. This is not the case in respect of the LGPS (or the Fund).

e. Fiduciaries have a duty to consider the need for diversification of investments.

f. There is a duty on fiduciaries to seek advice on matters which they do not understand, such as making investments, and on receiving that advice to act with prudence. Acting in good faith and sincerity is not enough – fiduciaries are held to a higher legal standard of care.

March 2014 KC opinion on duty owed by elected members in the LGPS

3.5. In 2014 The Local Government Association on behalf of the LGPS Shadow Scheme Advisory Board obtained legal advice from a King's Counsel about whether and to whom an LGPS administering authority owes a fiduciary duty and how the wider functions, aims or objectives of the administering authority should influence the discharge of its LGPS investment duties.

3.6. The advice was that:

a. In managing an LGPS fund, the administering authority has both fiduciary duties and public law duties (which are in practice likely to come to much the same thing).

b. The administering authority owes its primary fiduciary duties to the beneficiaries. While scheme employers (directly) and taxpayers (indirectly) contribute to the Fund, the relationship with employers and taxpayers is different from the relationship with the beneficiaries and gives rise to different legal considerations and administering authorities do not owe their primary fiduciary duty to them.

c. The administering authority's **power of investment must be exercised for investment purposes, and not for any wider purposes (such as political purposes)**. Investment decisions must therefore be directed towards achieving a wide variety of suitable investments, and to what is best for the financial position of the Fund and ultimately beneficiaries (balancing risk and return in the normal way). In pensions, the purpose of the investment power is usually to provide a pension – with contributions invested to provide a return, often several years into the future. The primary aim of an investment strategy is therefore to secure the best realistic return over the long-term, given the need to control for risks. This is an administering authority's primary investment objective (following a subsequent report by the Law Commission).

d. While a factor which goes to an administering authority's primary investment objective (and is therefore financial in nature) must always be considered, and while certain ESG factors are financial in this sense, not all ESG factors are financial – some are non-financial. The precise choice of investment may only be influenced by wider (non-financial) social, ethical or environmental considerations provided that does not risk material financial detriment to the Fund and other legal conditions are met. In taking account of any such considerations, the administering authority may not prefer its own particular 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 (nor may other scheme employers impose their views upon the administering authority).

e. The opinion recognised that investment decisions are for administering authorities to take and that authorities are under no legal obligation to consider investment decisions from any other perspective than the maximization of returns, whatever scope there may be for wider matters to be taken into account if they choose.

3.7. The advice cited two examples:

a. An administering authority may choose to take into account the public health implications of tobacco investment but only if the result of such consideration is the replacement of these investments with assets producing a similar return.

b. An administering authority may take account of social housing needs but only if an investment in a particular opportunity in this asset class stands up as an investment in its own right and the administering authority can demonstrate that it is not preferring its own interests over other scheme employers in making the investment.

Law Commission Guidance

3.8. In 2017 the Law Commission published its report on Pension Funds and Social Investment having been asked to look at how far pension funds may or should consider issues of social impact when making investment decisions. Set out in the report (p38) is the Commission's view, based on case law, that, if trustees wish to take into account non-financial factors when setting investment strategies and making investment decisions they should apply two tests, both of which must be met:

a. Trustees should have good reason to think that scheme members would share the concern; and

b. The decision should not involve a risk of significant financial detriment to the fund. Where trustees wish to take a decision based on non financial factors they should seek advice from their investment advisers on the effect of the decision on returns to the fund.

Statutory Guidance on Preparing and Maintaining an Investment Strategy Statement

3.9. Under the 2016 Investment Regulations, administering authorities must prepare and maintain their Investment Strategy Statement in accordance with the statutory guidance issued by DLUHC and invest in line with it.

3.10. Regulation 7(2)(e) of the 2016 Investment Regulations requires administering authorities to publish their policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments.

3.11. According to DLUHC’s statutory guidance, LGPS Funds:

a. should make the pursuit of a financial return their predominant concern;
b. should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors; and
c. may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the Fund and where they have good reason to think that scheme members would support their decision.

Palestine Solidarity Campaign and Jacqueline Lewis v Secretary of State for Communities and Local Government

3.12. The judgement of the Supreme Court in this case confirmed that, if Government issues guidance that goes beyond its own statutory powers for a different purpose than Parliament originally granted to it, then the relevant part of the guidance will be invalid. The issue in the case was whether the Government could prevent LGPS Funds from investing in a way that was inconsistent with UK foreign or defence policy. In essence, the Supreme Court held that this part of the guidance was unlawful and said that, although Government can set out guidance on how LGPS Funds should approach their investment obligations (in the framework of the ISS), it cannot dictate what Funds invest in. That remains a matter for Administering Authorities (acting through the Pension Committees to whom, consistent with their public law duties, they have delegated authority for investment decision-making) unless Parliament changes the law.

4. Governance Duties of Administering Authorities

4.1 The Council and its Committees have a duty not to abdicate future responsibility and not fetter their future discretion. The Council has delegated to the Pension Committee responsibilities and decision making powers in relation to the administration of the pension fund. Whilst the Council can encourage a particular approach this should fall short of direction or instruction. The Committee retains the discretion to exercise its responsibilities as it considers fit, and this cannot be fettered by Council requiring the Committee to exercise its discretion in a particular way.

This page is intentionally left blank