

<b>Essex Pension Fund Investment Steering Committee</b>	<b>ISC 05</b>
<b>Date: 21 October 2020</b>	

## **Financial Reporting Council (FRC) UK Stewardship Code 2020**

Report by the Independent Investment Adviser, Mark Stevens in consultation with the Interim Director for Essex Pension Fund, Investment Manager and Hymans Robertson

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### **1. Purpose of the Report**

- 1.1 To provide the Committee with an overview of the updated Financial Reporting Council (FRC) UK Stewardship Code 2020 as it relates to asset holders.
- 1.2 The report consists of an introduction to the Code followed by an itemised “RAG” table indicating the estimated current readiness of Essex Pension Fund (EPF) against each of the twelve principles and the necessary enhancements required to become a signatory.
- 1.3 The report also provides an outline of the potential next steps for the EPF to build the necessary stewardship reporting framework suitable to become a signatory to the Code for 2022.
- 1.4 Appendix 1 details each of the Code principles and provides analysis on the type of information and data the Code requires EPF to submit to be compliant.

### **2. Recommendation**

- 2.1 That the committee should:
  - note the report and the accompanying summary table and appendix;
  - discuss the scope of the new Code and the implications for EPF;
  - discuss the resources that will need to be deployed in order to become signatories; and
  - recommend that EPF commit to becoming a signatory of the Code for March 2022.

### **3. Introduction and background information**

- 3.1 This report sets out the necessary steps to be undertaken by the Essex Pension Fund (EPF) in order to become a founder signatory to the new 2020 UK Stewardship Code. Introduced by the Financial Reporting Council (FRC), the 2020 Code is more comprehensive than the original 2012 Code and sets higher stewardship standards for signatories.
- 3.2 The new Code took effect from 1<sup>st</sup> January 2020 and organisations may begin applying the principles embedded in the Code from that date. The deadline for those organisations wishing to be considered for the first list of signatories is 31<sup>st</sup> March 2021.
- 3.3 The report submitted at this time will cover the period 1<sup>st</sup> January-31<sup>st</sup> December 2020. It is anticipated that the FRC will complete their assessment of the submitted reports over the summer 2021. Signatories that meet the FRC's expectations will be included in a single list published for each type of applicant. EPF will be assessed as an asset owner. The FRC have stated that the initial signatories will not be graded or tiered in anyway. It is not anticipated that EPF will seek to submit a report for March 2021. Rather information will be documented during 2021 for a submission in 2022. Although not confirmed the FRC may have introduced some grading or tiered structure by this date.
- 3.4 There are a number of new features for the 2020 Code that make it significantly more demanding to become a signatory than the 2012 Code. Stewardship is newly defined as "the responsible allocation, management and oversight of capital to create long term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society".
- 3.5 The new Code is wider in scope and covers issues such the signatories' culture, values and business model. It includes all asset types and geographies and has a focus on outcomes and actions (not just policies). The reporting requirements for listed equity have been enhanced and expanded.

### **4. Information on the 2020 UK Stewardship Code for asset owners such as the Essex Pension Fund**

- 4.1 The updated 2020 Stewardship Code sets high stewardship standards for three distinct groups: asset owners; asset managers; and service providers. If the EPF decided to become a signatory, it will report on the principles set out in the Code for asset owners.

- 4.2 The Code comprises a set of twelve 'apply and explain' principles for asset owners. The report is expected to contain information in the following format.
- Context (why are we doing this?)
  - Activities (what are we doing, how are we engaging?)
  - Outcomes (what are the desired consequences, have these been achieved?)
- 4.3 The Code is not prescriptive in terms of approach and allows organisations to tailor their submission aligned with their own business model. It will be necessary for EPF Officers and Committee Members to agree an approach to applying the Code that is suitable to the organisation in terms of resource allocation and working with the various stakeholders.
- 4.4 The submission to the FRC is expected to be a single document, which gives a clear picture of how EPF has applied the Code over the previous twelve-month period. The focus of the report should be on activities and outcomes rather than on policies. It may be necessary to provide details such as case studies and relevant data where this will help provide a good understanding to the reader.
- 4.5 As an asset owner EPF will be outsourcing the specific engagement activities to asset managers who are employed by the Fund. It will be necessary to define a set of reporting criteria with each of the managers that will in turn feed into the overall reporting process going forward. The new Code is focused on outcomes achieved and activities undertaken rather than simply reporting on policies, this will need to be reflected in the reporting criteria agreed.
- 4.6 It also extends the scope of the Code beyond listed UK equity to all asset classes. This will in turn require that asset owners develop policies and engagement practises with all mangers employed including alternative assets and private market investments where these are owned.
- 4.7 Over the recent past the Committee together with Officers and Advisers have undertaken a substantial amount of work to develop a set of Responsible Investment (RI) beliefs and priorities. These have been incorporated into an updated Investment Strategy Statement (ISS).
- 4.8 In order to comply with the Code, it will be necessary to document how the principles that are incorporated into the ISS/RI policy of the Fund are monitored and implemented by the asset managers employed by the Fund. It will also be necessary to have the ability to demonstrate where the

implementation of the RI policy by the underlying managers has delivered positive outcomes over the period.

- 4.9 The Code reporting should be fair, balanced and understandable. This includes information on setbacks experienced and lessons learnt and information on where desired outcomes are expected to take longer than a year.
- 4.10 The table below sets out the twelve principles of the FRC 2020 Stewardship Code listed as P1 to P12 in three sections. Full explanation of the Principles can be found at Appendix 1. The RAG colour coding is an estimate of the current progress of the EPF in relation to completing a submission for each principle. The additional columns give a brief description of each principle and its objective. There follows, some high-level comments on the current status of EPF in fulfilling the principle and an estimate of the level of resource required to complete the outstanding work (low, moderate or substantial).

Purpose and Governance	Principle description	Stewardship Objective	Current Status	Resource Requirement	Comments
P1	Purpose of EPF and investment beliefs	Understanding of the strategy and culture of the signatory	Updated ISS and /RI workshops completed	<b>Low:</b> as majority of information already available	Anticipated to be a one-off documentation exercise, with periodic review
P2	EPF internal governance structure and resources	Identification of the governance structure and resources	Documentation of the governance structure and personnel and training will be required much already exists	<b>Low:</b> this will be a matter of formalising and documenting the various governance roles	Much of this documentation already exists it will be a matter of making it Code ready
P3	Management of conflicts of interests	Detail how any actual or potential conflicts are handled	Managers will need to be contacted about how conflicts are managed on behalf of the Fund	<b>Moderate:</b> initial documentation of process will be available with minimum updates needed for future submissions	ACCESS will need to provide updated information on this principle for pooled assets

Purpose and Governance	Principle description	Stewardship Objective	Current Status	Resource Requirement	Comments
P4	Identification / monitoring of systemic risks	Detail role played in industry initiatives in improvement of financial system	Mainly for fund manager input although integration into risk register seems appropriate	<b>Moderate:</b> another input from manager monitoring templates	Risk controls and fund rebalancing can be documented for this principle
P5	Review of effectiveness	Requirement to review and monitor policies for effectiveness	A review process will need to be agreed with managers	<b>Substantial:</b> requirement in the build out phase also impacts <b>P10</b>	A review structure will need to be agreed with every manager employed by the Fund
<b>Investment Approach</b>					
P6	Communication of stewardship approach to beneficiaries	EPF need to communicate why the stewardship activities adopted are appropriate for beneficiaries	Much of this can be derived from the ISS and the included in regular updates	<b>Low:</b> in terms of additional workload, some enhancements may be required to website or newsletters	The regular communication to beneficiaries either directly or via website can be repurposed to fulfil this principle
P7	Integration of Environment, Social and Governance (ESG) / RI policy in appointment of managers	Need for the integration of ESG/RI policies into mandate awards and on-going monitoring	Although this principle is partly implemented more work on evidencing will need to be carried out	<b>Moderate:</b> This work will form part of building of the manager reporting templates and a review of ITT processes	The on-going integration will be included on manager reporting templates. ACCESS will ultimately be involved.
P8	Monitoring, accountability and holding to account of managers and service providers on RI/ESG policy issues	Requirement to hold managers to account confirmation that assets run in line with RI policy	The existing process will need to be enhanced, documented and implemented	<b>Substantial:</b> Development of the enhanced monitoring process and reporting template will evolve into a regular review and engagement process with managers	Linked with P7  This can be thought of as the core BAU outcome of becoming a signatory to the Code.

Purpose and Governance	Principle description	Stewardship Objective	Current Status	Resource Requirement	Comments
Engagement					
P9	Engagement with issuers	Signatories via representatives should engage with issuers	Details of manager engagement and outcomes will need to be documented and evidenced	<b>Substantial:</b> although the data will be provided by managers a substantial amount of collation and documentation required	Linked to P7 and P8  This one of the major on-going tasks for signatories
P10	Collaborative engagement	Covering both direct EPF collaboration i.e. LAPFF and manager collaboration i.e. Climate 100+ UN PRI	Reporting and evidence process will need to be developed with managers	<b>Moderate:</b> the submission will need to provide specific examples of collaboration and outcomes	This will need to be incorporated in the manager monitoring template
P11	Escalation policy towards issuers	Explain the expectations for escalation set for asset managers of the Fund	This has not been formally agreed and will need to be included in the review policies developed with managers	<b>Low:</b> the additional information required for this principle can be included in the manager templates	Thought will need to be given for how different asset types are treated in this regard
Exercising rights & responsibilities					
P12	Exercising of rights including voting policy	Signatories must actively exercise rights across all geographies	Although voting policy is in place additional work will be required for other asset classes. Also, an important role for ACCESS	<b>Moderate:</b> a process and policy will need to be agreed with all managers including an on-going review process	This principle will form part of the extensive ESG/RI template used for monitoring external managers across multiple principles

## **5. Possible next steps for Essex Pension Fund for the period Q4 2020- Q1 2021**

- 5.1 Although there are twelve principles and a large amount of reporting required to become a signatory, it is entirely feasible and a worthy aspiration for EPF to become a signatory of the Code.
- 5.2 A submission by the first deadline date of 31<sup>st</sup> March 2020 would put a very significant strain on Officers and existing resources particularly in the presence of other major developments in the LGPS including McCloud, the new £95,000 cap, Goodwin and the Scheme Advisory Board Cost Cap Review. Becoming a signatory for March 2022, however, remains a realistic target.
- 5.3 There are a number of factors that make such an undertaking possible, although still very demanding in terms of resources and time. Although there are twelve separate principles a number of these overlap to some extent and procedures developed and information gathered for some of the principles can be applied to others where appropriate. The initial information gathering, development and collation of manager data will be a substantial task and will be the first phase of the project. This process will need to start during early 2021 at the latest in order to deliver the required information throughout the year.
- 5.4 There will be other LGPS funds that are in the process of assessing the feasibility of becoming signatories to the Code. In preparation of this paper there has been some anecdotal evidence that a number of funds have found that the amount of work and preparation required in becoming a signatory is prohibitive at this time. It would be beneficial that as an early step in the process of scoping this project that as much information as possible is gathered from other LGPS funds and pools, about possible pitfalls, expected workload and resource requirements.

## **6. Suggestions and observations for the initial phase of the project**

- 6.1 Suggested actions for the initial phase of the project include:
  - Scope out the resource requirements for the initial preparatory work; development of the reporting process, collation of data and on-going activities.
  - Obtain approval for resource allocation if required.

- The allocation of resources and development of the initial process will need to be achieved under COVID-19 working protocols, which could influence the amount of resource that will need to be utilised in the initial period.
- Undertake a gap analysis against the Code for all aspects of the currently specified ESG/RI Code adopted by the EPF to determine what additional steps will need to be taken in order to become a signatory.
- Review the ACCESS manager questionnaire on ESG/RI look to incorporate relevant data and information into EPF reporting requirements.
- Develop a comprehensive reporting template and process with the fund managers across every asset class, which will provide RI ESG data that is sufficiently detailed and accessible to be included in the submission.
- Communicate with managers what the expected outcomes of the RI engagement process they undertake on behalf of the scheme are and how these should be reported. Define the expectations that EPF has in relation to the various principles.
- Review communications to stakeholders and enhance where necessary. Document exiting achievements in this area.
- Review collaborative undertakings currently in place including LAPFF and the role of ACCESS. In addition, review the external managers collaboration and gather information on activities and successes. Include other ESG related engagements that sit outside the Code including the work of United National Principles of Responsible Investment (UN PRI), Climate Action 100+ and the use of such reporting benchmarks as Global Real Estate Sustainability Benchmarks (GRESB). Establish how these additional standards will enhance the submission.
- Develop and document a strategy of escalation with the external managers and undertake any outstanding escalations.

6.2 The initial report will cover the whole of 2021 and as such evidence of achievements will need to be gathered over the entire period. It is expected that this will be a significant task for the first few quarters but will be less of a time-consuming issue as the data and information is submitted by managers on a quarterly basis over the year.



## **7. Initial conclusion prior to undertaking a formal scope of the project**

- 7.1 Becoming a signatory to the 2020 UK Stewardship Code with a submission made in 2022 will be a significant undertaking for EPF. It will require dedicated resource in the initial set up and data-gathering phase. This phase will need to begin as soon as practicable during the final quarter of 2020 or early 2021.
- 7.2 Much of the initial work will be a data gathering exercise with the scheme's fund managers and the development of reporting templates that will provide the information required by the various principles of the Code. It would also be useful to gather as much information as possible from other LGPS funds and pools about their experience and approach to the Code. Learning from the experience of others who will be further into the process should be a very valuable exercise and could well save time and resources.
- 7.3 There will also be a substantial amount of work involved with documenting the ESG/RI policy work developed by EPF during 2020 for inclusion in the submission.

## **8. Financial and Resource Implications**

- 8.1 Signing up to the 2020 Stewardship Code would impact on current internal resources within EPF.
- 8.2 In addition, this could potentially impact the 3<sup>rd</sup> Party Supplier Budget that has been set for 2020/21 and would need to be considered when formulating the 2021/22 Budget.

## **9. Communication Implications**

- 9.1 A review of the EPF Communications Policy may need to take place to incorporate any potential communication requirements of signing up to the 2020 Stewardship Code.

### 1. Detail on the principles of the Code and the reporting requirements for signatories

- 1.1 Listed below are the twelve principles that are included in the 2020 UK Stewardship Code and relevant to an asset owner such as the Essex Pension Fund. The principles are grouped into four main sections. In producing a submission for the Code by the deadline of 31<sup>st</sup> March 2021 all the following sections will need to be included in the report.

### 2. Code Section 1: Purpose and Governance

Principle 1: “Signatories’ purpose, investment beliefs, strategy and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society”

- 2.1 The report will need to explain the purpose of the EPF, what it exists to do and the investment beliefs that are in place while carrying out this purpose. The report will require an explanation of what factors are considered important for the desired outcomes and why. Overall business model and strategy should also be included.
- 2.2 The outcome will be an explanation of how investment beliefs have guided stewardship and decision-making. Completing principle 1 would be possible in a moderate amount of time and would draw on work carried out during the RI workshops and ISS. It would remain valid for future submissions.

Principle 2: Signatories governance, resources and incentives support stewardship

- 2.3 Detail will need to be submitted on the governance structure that is in place and how resources are used to support stewardship. There will need to be a detailed report on these governance structures and why these were chosen. Mention will be made of how the stewardship function is resourced in terms of personnel, including the seniority and training of relevant staff.
- 2.4 Also detailed should be the services provided by external providers including research and analysis. The role and training of the Investment Committee will be relevant for this principle. The expected outcome will be an indication of

the effectiveness of the chosen governance structure in supporting stewardship and detail of any potential areas of improvement.

*Principle 3: Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first*

- 2.5 This principle details how conflicts of interest are handled and how the best interests of beneficiaries are maintained. Signatories should explain how conflicts are identified and managed including details of any actual or potential conflicts related to stewardship.
- 2.6 This section will be fairly straightforward to complete, although it will need to include input from fund managers on how they handle such matters on behalf on the scheme. An area where some additional information will need to be obtained is in the area of conflicts that might occur with the ACCESS pool or where conflicts arise with the policies of other ACCESS members. A clear conflicts policy will need to be established with the Joint Committee and ACCESS.

*Principle 4: Signatories identify and respond to market wide and systemic risks to promote a well-functioning financial system*

- 2.7 Signatories need to explain how they identify, respond and monitor market-wide and systemic risks to promote a well-functioning financial system. Detail of the role played in industry initiatives and how the scheme has worked with other stakeholders to promote improvement of function in financial markets.
- 2.8 Aspects of this principle may not be relevant to EPF as an asset owner. The outcome expected from this principle is that signatories should be able to disclose an assessment of their effectiveness in identifying and responding to market and systemic risks. This sits within the area of risk control, diversification, benchmarking and hedging.
- 2.9 Details of the rebalancing process carried out by the fund would also fall into this area of disclosure. Systemic risks cover issues such as climate change and business or market failures these can be covered by the interactions and governance process applied to the individual managers.

*Principle 5: Signatories review their policies, assure their processes and assess the effectiveness of their activities*

- 2.10 Signatories will need to explain how their stewardship policies are reviewed and monitored for effectiveness. What internal and external assurances are in place to demonstrate effective stewardship and why have these been chosen. How has the scheme ensured that stewardship reporting received is fair, balanced and understandable?
- 2.11 The aim here is to demonstrate that there is continual improvement in stewardship policies and practice and there is confidence in the information that is being obtained from stewardship activities carried out on behalf of the Fund (by external managers) is accurate.
- 2.12 Although this will be a time-consuming piece of work it will be achievable for EPF to put in place for the initial deadline. Internal assurance can be from Internal Audit or senior staff and external assurance can be received from independent third parties and this could include Hymans Robertson or Aon and there may also be a role for the ACCESS and Link operations.

**3. Code Section 2: Investment Approach**

*Principle 6: Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them*

- 3.1 This principle will require the scheme to publish the details of the profile of the membership the nature of the liabilities and the investment time horizon that is used and why this is appropriate.
- 3.2 Signatories need to take account the beneficial needs of the membership and communicate activities and outcomes of their stewardship and RI approach to them. Outcomes include how the effectiveness of the RI policy is evaluated and the methods employed to form the policy. Details of the various consultations with beneficiaries that have been carried out will also need to be reported.
- 3.3 There is a lot of detail in the Code on this principle and any submission will need to include a full explanation of how the RI Policy of the Committee was formed and which stakeholders were involved in the process, which views were sought. This will be a substantial piece of work for the first year but much easier in later years. The training and workshops undertaken by the

Committee combined with the consultation with the various stakeholders will form the basis of this response.

*Principle 7: Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities*

- 3.4 Signatories will need explain how they have integrated their ESG policies throughout the entire process of awarding mandates and on-going monitoring of managers including exiting of mandates. Any different approaches that have been adopted between asset classes and geographies should also be included and explained.
- 3.5 Where new tenders have been undertaken these should include all material ESG issues and a requirement to integrate stewardship into the investment process. There will need to be an explanation of the RI/ESG issues prioritised and how these issues are accounted for before making the initial investment decision/mandate award, how during the investment period these priorities remain integrated as well as their impact on decisions relating to exiting an investment.
- 3.6 This is a major principle and will be the output from a fully integrated RI/ESG policy, it will be necessary to explain how the RI/ESG policy operates and informs all aspects of the investment monitoring of managers and assets in the fund.
- 3.7 This principle is the output of all the work that will need to be in place before signing the Code. The outcome of this principle will be an explanation of how information gathered throughout the stewardship policy has informed the awarding of mandates and the on-going monitoring of managers for the scheme. Reference should also be made of how these procedures have best served the beneficiaries of the scheme.

*Principle 8: Signatories monitor and hold to account managers and/or service providers*

- 3.8 Signatories need to monitor and hold to account managers and or service providers. An explanation should be given in the report how the monitoring of managers is taking place it should also cover where the managers have delivered on the needs of the scheme and where they have not. The example given in the Code for asset owners reiterates the need to monitor investment

managers making sure that the assets have been run in alignment with the RI policies of the scheme.

- 3.9 This principle is similar to principle 7 above but this covers the day-to-day BAU of monitoring where principle 7 focuses more on how stewardship and ESG are integrated into mandate specification.
- 3.10 The information for principle 8 will be available from the managers and form part of on-going reporting back to the scheme that will be put in place. Pulling all this together and reviewing all the information will be a major task given the number of relationships that exist in the Fund.
- 3.11 One of the major changes to the 2020 Code from the 2012 version is the inclusion of all asset classes and geographies so every manager will need to be included. The development of the manager reporting templates and the development of the process for collection and processing will be one of the first major tasks undertaken if the Committee moves forward with the proposal to become a signatory.

#### **4. Code Section 3: Engagement**

##### **Principle 9: Signatories engage with issuers to maintain or enhance the value of assets**

- 4.1 Signatories should explain the expectations they have set for fund managers who engage on their behalf. Detail how the priorities for engagement have been arrived at and provide examples of the precise objectives of this engagement and the various methods that have been used. The reasons for the adopted approach will need to reference disclosures in principles 1 and 6 above.
- 4.2 Signatories via their representatives should engage with issuers, this could be in many different forms including meeting with the Chair and Committee Members and management, raising concerns in a written format as well as working alongside other asset owners and investor organisations.
- 4.3 This part of the report is entirely manageable and will be a formal documentation of ESG engagement activities carried out by the scheme's fund managers. However as with many of the principles it will take coordination at the EPF to document the specific outcomes achieved and the on-going status of engagement projects. These types of activity would be suitable for Hymans Robertson to collate on behalf of the Fund if resourcing was an issue.

*Principle 10: Signatories, where necessary, participate in the collaborative engagement to influence issuers*

- 4.4 Signatories should disclose what collaborative engagement they are involved in and why. This can be a report of both direct collaborative engagements by EPF and/or that carried out by external managers in collaboration. In terms of the written submission this would involve giving examples of where collaboration has taken place.
- 4.5 Outcomes should detail actual changes made by companies as a result of the engagement and how outcomes have informed investment decisions. Much of the emphasis here will once again be on the asset managers however for EPF it will be possible to highlight the work of Local Authority Pension Fund Forum (LAPFF) and seek to influence LAPFF in terms of activities undertaken, particularly when working with other ACCESS funds.
- 4.6 Some LGPS funds have signed up to Climate Action 100+, which would be an example of collaborative engagement. There are many initiatives that are being undertaken by the scheme's managers that would form part of this submission.

*Principle 11: Signatories where necessary, escalate stewardship activities to influence issuers*

- 4.7 Signatories will need to explain the expectations for escalation they have set for asset managers working on their behalf. Some examples of how the escalation policy differs between asset types and geographies should be included.
- 4.8 Outcomes will include whether any changes or action has resulted from the escalation and how the outcomes of escalation have influenced investment behaviour in terms of buy sell hold. Most escalation of this type relating to governance issues will be in the hands of the asset managers.
- 4.9 In terms of EPF reporting as a signatory it will be a matter of collecting the information from fund managers and holding them to account for how they are progressing with the various ESG issues they are tracking within their portfolios and importantly how their investment activity is being driven by the outcomes of the various escalations.
- 4.10 In addition, EPF may on occasion need to escalate issues directly with fund managers relating to the activities and culture of the managers themselves. Any such escalation would also form part of the submission on principle 11.

## **5. Code Section 4: Exercising rights and responsibilities**

### **Principle 12 Signatories actively exercise their rights and responsibilities**

- 5.1 Signatories must actively exercise their rights and responsibilities. For listed equity this will be a minimum of having a voting policy. But all asset classes will need to be addressed. Also, explanation will need to be given as to how rights are exercised in different geographies and for alternative assets.
- 5.2 The output of this principle is mainly in the hands of asset managers employed by the scheme, but thought will need to be given as to how to monitor this in the pooled funds of ACCESS. Work will need to be done to understand how rights and responsibilities operate in alternative assets before this submission deadline.