Date: 14 June 2021

Response to the DWP's Call for Evidence: 'Consideration of social risks and opportunities by occupational pension schemes'

Background

- The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 83 local authority pension funds and seven LGPS pool companies, based in the UK with combined assets of over £300 billion. It exists to promote the investment interests of the funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest.

Response

The Local Authority Pension Fund Forum (hereafter LAPFF or the Forum) welcomes the opportunity to respond to this important consultation and commends the department for initiating the call for evidence. Although this call for evidence does not cover reforms which will affect LGPS funds, as pension regulation and legislation for our members' sector tends in the end to mirror those within the purview of DWP we wished to submit a response. In this section we outline our overall position before addressing the consultation questions in the following section.

LAPFF has long recognised the financial materiality of social risks for investments. LAPFF considers companies that account for worker, community and consumer interests are contributing to sustainable value creation and will earlier identify problems that could lead to material loss of value and social license to operate.

The Forum has engaged companies on social risks since its inception thirty years ago. LAPFF has engaged companies on their approach to human rights, employment standards and the impact of their products. More specifically, this has covered concerns about reputational, legal, operational, and financial impacts of inadequate approaches to, among other things, the health and safety of employees, employee rights of association, the impact of products, how company activities affect local communities and the use of child labour. As the response to question 7 outlines, the Forum has undertaken hundreds of engagements across these issues. These have covered engagement in Europe, for example high profile engagements with Sports Direct and Ryanair regarding labour standards. Further afield, the Forum has been engaging with mining companies following a number of tailing disasters, which have killed hundreds, destroyed communities, and led to the loss of billions of investment value.

Despite the importance of social factors, they are often the ‘Cinderella’ of responsible investment; overlooked in voting because of the focus on governance arrangements and not viewed as material as the environmental crisis. In truth, social factors are integral to both the governance of the company and addressing climate change. As many companies note employees are their most important assets but rarely feature prominently in company disclosures.

This is compounded by the lack of accurate and comparable data and narrative disclosure around employment standards and human rights from which to judge a company’s performance and sustainability. From a market perspective it risks the misallocation of capital and creates systemic risks. Thus a company’s social risks are a black box for investors who too often can only understand these risks and failings when it is too late.

There are efforts, such as the government-backed Workforce Disclosure Initiative, to increase available information. However, their voluntary nature means comparisons are difficult where disclosure is far from universal. Equally, new disclosure initiatives often exclude the social. For example, the Taskforce on Climate-related Financial Disclosure (TCFD) was welcomed by the Forum for its approach to reporting climate change risks. However, the TCFD framework does not include recommendations for any reporting of the social risks associated with decarbonising operations and products, which are a significant material risk of climate change and to efforts to achieve net zero.

The central message of this response is therefore that a starting point, from an investor perspective, is that there needs to be a consistent set of disclosures (both quantitative and narrative reporting) on which companies are required to report. Details about these disclosures covering human capital management and human rights are outlined in question 4. Without such requirements, responsible investors will be acting with one hand tied behind our backs.

Detailed response

Q1: Does your pension scheme, or do schemes you advise, have a policy on financially material social factors? In this policy, are social factors discussed separately to ESG factors in general?

The Forum's policy guide (which can be accessed here: https://lapfforum.org/wp-content/uploads/2020/05/2020_LAPFF_Policies_Full_Version.pdf) sets out our position of a range of ESG factors and is based on the agreement of our members. The document is not separated into separate E, S and G sections. However, it contains all three and covers a range of distinct social risks.

These social risks cover employment and human rights, including living wages, precarious work, health and safety, training, employment rights and freedom of association, blacklisting, workforce diversity, supply chain conditions, UN Guiding Principles on Business and Human Rights, human rights of those affected by operations, and modern-day slavery.

The inclusion of all these factors in the Forum's policy guide, which also includes environmental and governance issues, is based on evidence of material implications. The Forum's position is that ESG factors are financially material for companies and investors and should not be treated separately in considerations or as ethical issues or 'non-financial factors'. Separating social (and environmental and governance) issues and non-financial factors is viewed as a false dichotomy. The Forum's position is that companies that pay close attention to workforce issues and human rights will increase operational efficiency, innovation, and staff retention and ultimately shareholder value because they will create a positive environment and mission for staff.

Having clearly stated positions on issues enables the Forum to have consistent positions with companies and set out our expectations of them. This is essential when we engage with companies and, before that, to identify companies to engage. Not having a clear position on social risks or talking in generalities as part of a general approach to ESG would in the view of LAPFF lead to less effective engagement and management of risks.

The Forum's members are diverse and the LAPFF is aware of funds and pools which have integrated social risks into investment policy, voting guidance to asset managers and reporting to stakeholders.

Q2: Does your scheme, or do schemes you advise, have (a)a stewardship policy and/or (b) a voting policy that specify covering social factors?

As noted Forum members range in their approach, and different approaches are often shaped by the size and resources of the fund or pool. Some Forum members are signatories to the UK Stewardship Code and some member funds' stewardship policies refer to ESG factors. These policies cover approaches to engagement (including ways of escalating activities) collaboration with other investors on engagements, approach to voting, integrating ESG factors into investment decisions, approach to asset management selection and holding them to account, engaging with policymakers and reporting and engaging stakeholders. They tend to outline the overall approach to stewardship with reference to ESG factors. However, the detailed focus of their efforts on social risks will be found in their responsible investment policy. Some members advise that the two documents should be read in conjunction with each other.

Many members have voting guidelines and use proxy advisers and asset managers which will have their own stewardship policies, some of which include social risks. These can include voting on a case-by-case basis, including in relation to LAPFF advice (see below). Voting guidelines can refer to whether the company has policies on diversity, health and safety, freedom of association and expectations around disclosure of employment performance indicators. These guidelines can also include reporting expectations around managing supply chain and human rights risks and investment and consideration of communities in which companies operate.

Social risks often feature less prominently because of the nature of resolutions on the AGM proxy on director elections. Advice on voting often focuses on the governance component of ESG as directors are up for (re-)election so focus on their suitability alongside other required votes relating to report and accounts, audit, capital stewardship and executive remuneration. As environmental, mainly climate change, issues have risen in importance so there have been growing expectations and requirements around disclosure and action which are being voted on. This said, voting guidelines and responsible investment policies often support taking positions on shareholder proposals of social risks – something more common in a US context.

The Forum's activities support our members both in considering social risks as part of investors' stewardship responsibilities and by issuing voting recommendations. Alongside engaging companies on social risks, LAPFF provides information and guides on how to consider social factors and engage with policymakers on the issues – such as this consultation. The Forum also issues voting alerts on social risks – these are based on the Forum's policy guide which feature social risks. These voting alerts are often a way of escalating engagement activity and highlight social risks that may not be apparent by looking exclusively at company disclosures.

Q3: On which social factors do your scheme's investment and stewardship policies focus? What was the rationale for deciding to focus on these particular social factors? Do you refer to any international standards, such as those relating to human rights or labour rights?

LAPFF's policies focus on a wide range of issues including: living wages, precarious work, health and safety, training, employment rights and freedom of association, 'blacklisting', workforce diversity, supply chain conditions, UN Guiding Principles on Business and Human Rights, human rights of those affected by operations, and modern-day slavery.

These policies have been identified as posing material risks to investors. The Forum's approach is based on research examining varied legal, regulatory, reputational, operational, and financial risks associated with them. They are identified by member concerns, independent research into risks, and engagement with others including employee representatives and affected communities. Through such methods we can understand social factors without being solely reliant on company disclosures. The focus of resources on specific companies and risks is subject to change. This will be based on the level of risks posed and company approaches to managing risks. Successful engagements can help change company behaviour and reduce risks at which point the Forum's focus will change.

The Forum makes reference in its policy guide to international standards, including UN Guiding Principles on Business and Human Rights. The work of the Forum draws on international human rights law, ILO conventions, as well as national statutory requirements, for example Modern Slavery Act. An example of this is included in question 7 in relation to the mining sector.

The Forum encourages companies to go beyond legal requirements but is sceptical about industry codes, which can be weak, misinterpret the law and be used as an excuse to overlook their legal obligations. Voluntary guidelines and standards from industry and corporates are decades old but have failed to prove their worth. LAPFF therefore supports national legal frameworks on human rights due diligence which have been emerging over the last ten years or so (for example, the California Supply Chain Transparency Act and French loi de viligence). This legislative approach is considered to create the appropriate incentives for business and markets to drive up environmental and social standards instead of allowing a race to the bottom.

Q4: Which resources have you found useful when seeking to understand and evaluate social factors either for your scheme or a scheme you advise? Do you feel that you have sufficient understanding of how companies perform on social issues?

The Forum makes use of publicly disclosed information from companies. However, proper consideration of the risks that companies face requires looking beyond what companies wish to present, especially when relatively little information on social risks is required (as outlined below).

LAPFF draws on the work of NGOs and trade unions and journalists in understanding specific risks at individual companies. This involves using publicly available material. The Forum's approach is also to listen to views of stakeholders. This includes speaking to communities and employees about the challenges they face as well as their representatives. It also seeks to be agile to changing circumstances, for example, engaging with companies and sectors on the social risks associated with coronavirus.

Research produced and commissioned by government alongside academic and grey literature are used to understand overall levels of risks and help when distinguishing between company approaches.

The Workforce Disclosure Initiative has helped provide additional information related to the nature of work and employment standards. However, it is voluntary, meaning that not all companies have to disclose. This makes comparisons difficult and it can therefore be hard to understand the relative risks different companies are facing.

As such, reporting on social risk factors is inadequate. For investors to fully assess social factors, place a distinguishing value on a company, undertake engagement with companies with adequate information and fully integrate social risks into voting guidelines, requires much greater disclosure.

The Forum's responsible investment policy guide outlines a number of areas where reporting would be beneficial to responsible investors. These sections are reproduced below, firstly on human capital management:

> *LAPFF supports the call for narrative reporting that includes both quantitative and qualitative indicators, but does so in a way that conveys a meaningful description of how human capital contributes to the long-term value of the company.*

The lack of appropriate metrics to assess a company's human capital management, as well as a lack of investor knowledge about how to use human capital information, is a large hurdle to effective reporting in this area. A slew of metrics have been proposed by a range of organisations but few seem as yet to have gained much traction within corporate human capital management thinking.

The literature suggests that a link between human capital management and business model and strategy is a key element of reporting, but it also appears that investors have backed down from proposing specific metrics and indicators. One observation is that while there has been a call for a mixture of quantitative and qualitative reporting on human capital management, the concrete indicators proposed thus far often fall into the quantitative category.

While quantitative reporting is undoubtedly important, it is notoriously difficult to quantify social impacts in a meaningful way. A list of targets and numbers is often meaningless without a qualitative context or explanation for the quantitative indicators. Therefore, quantitative information needs to be connected up with qualitative reporting in a meaningful way so that investors can understand how a company's human capital management is creating value.

LAPFF's position of non-financial disclosure related to CSR is:

LAPFF encourages companies to describe how their corporate responsibility and sustainability policies align with and support long-term corporate strategy.

We caution against the approach used by some reporting companies, which appears to us to have become an annual restatement of boilerplate text relating to generic, rather than company-specific risks, opportunities, and activities. On the question of exercising responsibilities, the Financial Reporting Council states: 'The board should monitor the quality of the information it receives and ensure that it is of a sufficient quality to allow effective decision-making.'

In the UK context, the Forum's commitment to improving the quality of corporate reporting is shown through its support of the Kay Review and recommendations from the Kay Review assessment. The Forum considers that the strategic report requirements are important in providing the most *useful disclosure, including ESG disclosure, for shareholders. For example, the guidance refers to the provision of forward looking information prepared 'so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.'*

LAPFF considers reporting could still be improved in relation to:

- *Capital allocation: we believe the process by which a board allocates capital, including the trade-offs it makes between competing projects and stakeholders is critical to a shareholder's understanding of a company's ability to create value and its orientation to stakeholders and should be disclosed at a level of detail not seriously prejudicial to the company.*
- *Employee engagement: the level of employee engagement in a company is often a determining factor in company performance. Nonetheless, whilst there is a great deal of (boilerplate) reporting on how companies attract and retain staff there is very little (almost no) discussion of the policies, process and cultural factors companies use to motivate people to perform.*
- *ESG (environmental, social and governance) and human rights contribution to strategy and performance: Although a substantial proportion of companies refer to ESG and human rights matters in setting out their strategy, few companies comment on how their ESG and human rights performance contributes to this strategy according to our definition of the term and further make the consequent significant link to performance.*

LAPFF supports the FRC's call for reporting on material information in the annual report and agrees that inclusion of immaterial and duplicate information can detract from clear messaging. Improved reporting on linkages between information presented and business performance is also welcome.

Its position regarding non-financial incentives is thus:

Companies should endeavour to develop non-financial incentives and reward systems to help attract, motivate and retain staff.

Most executives report being driven by non-monetary rewards including a sense of achievement, of being part of a successful management team, of *working in a place where they are in tune with the organisation's values and objectives, and of building a great company. These themes recur in most studies of employee motivation and engagement. It is widely acknowledged that senior executives have their own motivation calculus, their own set of needs and desired results and that, to most, money is simply a form of calibration, or a way by which senior executives compare themselves with their peers. Equally, it has been found that the companies that most effectively motivate their employees to pursue future growth and concentrate on current performance take care to supplement financial rewards with unusually inclusive and motivating corporate cultures. At a company of this kind, employees see a close fit between its long-term interests and their own. Consequently, they are better motivated to work diligently and creatively to serve the business well. In such companies, the culture and incentive schemes serve to reinforce each other. Nevertheless, it is virtually non-existent for a company to report extensively on how it uses non-monetary reward systems to attract and retain staff, to motivate them to perform or indeed to align their interests with the interests of shareholders by motivating them to deliver long-term business success. We consider this a material omission and, if addressed, would significantly help stakeholders appraise the quality of a company's organisational capital.*

It's position on human rights is:

The Forum encourages companies to adopt human rights policies and management practices in line with the UN Guiding Principles on Business and Human Rights and believes these policies and practices should be disclosed to shareholders.

The Forum views human rights as an important business issue and a potential indicator of investment risk, in line with the position in the UK Companies Act. The Forum has a long history of engaging companies on human rights issues, particularly regarding health, safety and employment practices but not limited to these areas. Corporate respect for human rights covers both direct and indirect impacts by companies. In other words, it extends to include the rights of people that are not only directly employed by companies, but those individuals and communities that may be affected by a company's operations. Companies operating in conflict zones or those with significant operational footprints may be particularly exposed to human rights risks and may require enhanced protection of adversely affected stakeholders and disclosure of steps companies are taking to respect human rights.

We take the view that the way companies manage human rights can affect companies' reputations and their ability to operate and grow their businesses effectively, sustainably, and profitably. Therefore, improved disclosure of how companies monitor and respond to human rights risks (including labour, health and safety, and community-based risks), as well as remedial measures they undertake when adverse human rights impacts are uncovered, would be welcomed.

As the above examples demonstrate, there are large gaps in the reporting framework. Requiring companies to produce a set of comparable data and narrative reporting would ensure greater scrutiny is placed on social risks and enable investors to distinguish value. Without such information company engagement by responsible investors is greatly hindered. It is vitally important that what is being reported accurately reflects social factors. LAPFF's experience is that companies often fail to undertake adequate stakeholder mapping so do not identify their full range of affected stakeholders. This means companies may not know the extent of their risk, impacts and opportunities.

Consideration of social factors should also not be viewed in isolation to the other disclosure initiatives on ESG. For example, new requirements to report against the Task Force for Climate-related Financial Disclosures recommendations are very much welcomed by the Forum. However, TCFD does not include social risks despite there being significant risks, as well as opportunities, to both employees and communities, and through the supply chains.

Q5: What approach do you, or the trustees you advise, take to managing the (a) risks and (b) opportunities associated with social factors? Why have you chosen this approach?

LAPFF engages with companies on behalf of its members. The approach adopted is to identify social risks and companies facing social risks, and then engage with these companies. The engagement approach taken is constructive. However, while the Forum believes in a constructive dialogue it sets itself engagement goals to ensure engagements are having the desired impact. While LAPFF and investee companies may not always agree, the Forum expects to see progress and continues to engage where more is deemed to be needed. The Forum escalates engagements, including through issuing voting recommendations to members, where progress has stalled.

Q6: If this is delegated to asset managers, how do you ensure and monitor that they manage the risks and opportunities associated with social factors?

Delegating shareholder engagement does not mean that fund managers should take full control of shareholder activism. Delegation still legally requires responsible stewardship by public pension fund trustees of their managers' delegated responsibilities, in line with the UK Stewardship Code. LAPFF encourages trustees to hold fund managers to account by regularly reviewing their performance and company engagement activities. The Forum's position is that even if resources are limited, trustees can assess effectiveness of engagements through regular (e.g. quarterly) reports from a fund's managers or by meeting them. LAPFF assists, for example, by encouraging its members to share LAPFF voting alerts with their asset managers to ensure that asset managers are implementing member expectations in their voting and engagement activities. Ensuring social and environmental factors are considered in asset manager selection is also essential.

There are a range of reasons why pension funds should not overly rely on their managers to perform stewardship functions. As the Myners' review of institutional investment in 2001 noted about managers, which still holds true today, "there is a culture in the financial community of wanting to avoid public confrontation with companies." There remain potential and real conflicts of interest. Fund managers manage multiple pension funds, including those of investee companies. Raising concerns and being involved in robust engagement over social or other responsible investment issues at a company for whom they manage the pension fund, risks them losing that contract and potentially business more broadly. Managers may also have an interest in not placing the spotlight on the social risks at a company for fear of raising questions about the wisdom of their original decision to invest in the company. LGPS regulations also mean ultimate responsible investment responsibilities are at an individual fund level.

Q7: a) Have the trustees of your scheme, or a scheme you advise, undertaken stewardship (engagement or voting) with an investee company on a social factor in the past 5 years, whether directly or through an asset manager? (b) If yes, please provide details including why you felt this was necessary, what was done and the impact of your intervention. (c) If no, then please provide details including what disincentives and barriers you faced in undertaking stewardship activities (engagement or voting) with an investee company?

In the past five years the Forum has undertaken over 700 engagement activities on a wide range of social factors. The way that LAPFF operates is different, rather than organisations engaging companies on pension funds' behalf, the engagement is undertaken by pension fund trustees themselves as asset owners. LAPFF executive members, who are trustees or officers of individual funds, lead the engagement meetings with company chairs and attend AGMs. We consider this approach to engagement both unique and more effective.

As outlined, social risks are material and therefore engagement is deemed necessary to protect members from adverse legal, reputational, operational, and financial risks which will impact the long-term value of a company. On the positive side, engagements seek to recognise good practice (and enable members to place a distinguishing value on those with 'good' practices) and encourage better practice to enhance the value of the company. The level of engagement that LAPFF has undertaken means that they have ranged from serious concerns to those which seek to improve on already good company practice – but the focus is largely on the former. Not all engagements have the effect that we desire and engagements can take some time to result in a positive outcome (see Ryanair example below). Given the large number of engagements on social factors our response focuses on two examples. Engagements are reported in LAPFF's annual and quarterly engagement reports. These reports are produced for members and available to the public on our website (https://lapfforum.org/publications/category/annual-reports/) where examples of other engagements can be found.

Ryanair

LAPFF has raised concerns about precarious work and its impact on shareholder value. The Forum was aware of concerns regarding employment standards and practices at Ryanair, which it first raised at the company's AGM in 2014. There were also concerns with governance arrangements.

Following concerns regarding employment relations, LAPFF engaged with the company. LAPFF attended AGMs, met with company representatives and also issued voting alerts recommending members vote a specific way on certain resolutions. The issues first raised in 2014 came to a head in 2018 when strike action led to widespread travel disruption and the issuance of a profit warning.

Despite numerous efforts, the Forum was not able to meet with a Ryanair board member. At the 2018 AGM, 30% of shareholders voted against the re-electiojn of Mr Bonderman, the company chair.

Concerned about the continuing human capital management and governance issues at Ryanair, the Forum announced a proposal to file a shareholder resolution ahead of the company's 2019 AGM, with the aim of replacing the Chair David Bonderman, who had been on the board for 22 years, and ensuring that a coherent succession plan is in place for chief executive Michael O'Leary.

Following the announcement of the proposed LAPFF resolution Ryanair set out its intention that Mr. Bonderman, along with its current Senior Independent Director, Kyran McLaughlin, would step down by Ryanair's 2020 AGM.

Mining

The mining sector has long faced challenges from investors on climate change. Along with CCLA and other investors, LAPFF played a role in developing the 2016 Aiming for A resolutions filed with AngloAmerican, Glencore, and Rio Tinto. However, the sector has also long faced human rights challenges. These challenges have been magnified in the last few years through the tailings dam collapses at Mariana and Brumadinho, and the destruction of culturally significant caves at Juukan Gorge in mid-2020.

On the back of Brumadinho and Juukan Gorge in particular, the human rights implications of mining activities have started to increase in importance relative to climate impacts of mining companies. One aspect of this awareness has emerged through the just transition movement for investors - that societies cannot make effective transitions to low carbon economies without adequate consideration of and action in relation to social actors, including workers and communities. The other angle of this development is the increased role of community voice contributing to investor understanding of corporate conduct. More and more investors are joining calls with community members and workers and are understanding how to incorporate community voice into their investment decision-making. LAPFF specifically has focused on engaging with mining company chairs to ensure that they see effective community engagement as an important strategic consideration for their companies.

The result is increased pressure on mining companies to comply with international human rights standards, both legal and voluntary. This includes an imperative for mining companies to uphold the new Global Tailings Standard produced by the Principles for Responsible Investment, UNEP, and the International Council on Mining and Metals. On a number of occasions, the Forum has returned to the UN Guiding Principles on Business and Human Rights to seek clarity on what to request of companies in relation to their human rights activities. Of particular relevance has been the provision in UNGP 11, stating: 'The responsibility to respect human rights is a global standard of expected conduct for all business enterprises wherever they operate. It exists independently of States' abilities and/or willingness to fulfil their own human rights obligations, and does not diminish those obligations. And it exists over and above compliance with national laws and regulations protecting human rights'. For the first time, a group of investors has convened to discuss the mining sector and engagement with affected communities in order to help inform this standard of expected conduct.

This group represents a powerful additional tool in investors’ engagement toolkit with mining companies, one the Forum expects to yield significant benefits in both human rights and investment terms.