Principles for Responsible Investment

UNEP Finance Initiative — Changing finance, financing change | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ENVIRONMENT AGENCY PENSION FUND

COUNTRY
UK

TYPE OF FUND/ORGANISATION
Government agency pension fund

TOTAL ASSETS
£2.2 billion (US$ 3.5 billion) as at March 2013

"In a recent £250 million real assets tender, EAPF illustrated how clear and stringent ESG requirements can be embedded into tendering and appointment processes."

INTRODUCTION

The Environment Agency Pension Fund (EAPF) is one of the largest local government pension schemes in the UK. It is a defined benefit pension scheme open to all of the Environment Agency's 12,000 employees. The Fund invests according to responsible investment principles: environmental, social and governance (ESG) issues are key factors in all of its investment processes. By 2015, EAPF aims to invest 25% of its fund in companies that make a positive contribution to a green and sustainable economy, in part by investing in environmental themed funds.

In April 2013 EAPF took another step towards this goal when it awarded a £250 million (US$ 401 million) real assets mandate to The Townsend Group, a global real estate investment manager. It will invest in sustainable infrastructure, property, forestry/timberland and agriculture/farmland funds.

This case study describes the stringent ESG requirements that EAPF applied throughout the manager selection and appointment process for this mandate. It is one of a series of case studies produced by the PRI Initiative's Environmental and Social Themed Investing Work Stream.

KEY POINTS

- A thorough understanding of the financial materiality of environmental trends underpins EAPF's overall investment strategy and its decision to make a substantial new allocation to sustainable real assets.
- EAPF's tender documentation for this mandate explicitly sets out its expectations of prospective managers in terms of ESG matters and the standards they must meet. They were required to demonstrate, among other things, their ESG policies, capabilities, track record and performance. These elements formed a substantial part of the final score calculated for each prospective manager and the selection decision.
- EAPF also set out the ESG policies that it expects managers to follow and its reporting and monitoring requirements. This includes taking part in footprinting and impact measurement exercises undertaken by independent organisations appointed by EAPF.
- EAPF provided detailed guidance on the types of assets that it deems 'preferable, acceptable, restricted and excluded'. EAPF defines these using well-established sustainability standards – rather than relying on a manager's definitions or approach to asset selection.

RATIONALE

EAPF's aims to generate the best risk-adjusted returns possible in a financially and environmentally responsible manner. EAPF believes that climate change, resource scarcity and biodiversity loss – along with many other environmental trends – represent significant investment risks but that they can also lead to attractive return opportunities.

By 2015, it aims to invest 25% in companies and assets that make a positive contribution to a green and sustainable economy. Investing in environmental themed funds is one of several strategies that EAPF uses to work towards this target. It hopes to capitalise on the attractive potential returns available from low-carbon and environmentally responsible investments.

TYPE AND STRUCTURE OF INVESTMENTS

EAPF has invested in two environmental themed funds for several years: a global equities fund run by Impax and part of a portfolio of global private equity funds run by Robeco. Today these investments amount to around £100 million (US$ 160 million). In April 2013, EAPF awarded a £250 million (US$ 401 million) sustainable real assets mandate to The Townsend Group. A significant proportion of this mandate will invest in environmentally themed funds in property, sustainable infrastructure, forestry/timberland and agriculture/farmland.

APPROACH

While EAPF aims to achieve a positive contribution to a green and sustainable economy with its investments in real assets, it is aware of the many ESG risks associated with these. The risks range from potential biodiversity damage or breaches of certification standards, to community concerns and animal welfare. Moreover, their relative illiquidity exacerbates these risks due to the difficulty of divesting quickly. The Fund therefore placed a particularly strong emphasis on ESG issues throughout the selection and appointment process for this mandate. The advertisement and tender documents[1] made EAPF's ESG requirements clear. These included:

- A requirement that the appointed provider manage the assets in accordance with EAPF's responsible investment and environmental overlay strategies and ESG policies;
- A preference for the manager to show a commitment to responsible investment, through PRI membership or support for similar initiatives;
- Demonstrable in-depth knowledge, capabilities and resources, and a strong track record in responsible investment and ESG issues;
- A robust approach to risk management, including identifying, analysing and integrating ESG-related financial risks;
- A requirement that the manager assess the environmental impact of a proposed fund's investment strategy and the capability of its management with respect to the environmental impact and management of the underlying assets;
- A requirement that the manager quickly inform EAPF of any potential ESG issues relating to a prospective investment;
- A requirement that the manager adopt sound, innovative and proactive approaches to managing its negative impact on the environment and wildlife and that it commit to equality, diversity and good practice in all aspects of employment;
- That, at the request of EAPF, it obtain information on ESG management and performance reporting that EAPF may require from the funds it invests in;
- A requirement to monitor key ESG performance indicators across the portfolio, take mitigating actions where necessary and to participate in EAPF's annual environmental/carbon footprinting exercise, where practicable; and
- Willingness to help EAPF comply with its duties under the PRI and the UK Financial Reporting Council's Stewardship Code.

EAPF also sets out a clear hierarchy of the types of assets and/or environmental guidelines or standards the assets should meet. For example, with respect to timberland and forestry, this was defined as:

- **Preferred assets:** Forest Stewardship Council (FSC)
- **Acceptable assets:** Programme for the Endorsement of Forest Certification (PEFC) certification.
- **Restricted assets:** assets where the manager is working towards, but has not yet achieved FSC/SFI certification.
- **Excluded assets:** illegal logging involving deforestation; operations in UNESCO World Heritage Sites; operations in wetlands protected by Ramsar (a wetlands convention); projects or operations involving primary or high conservation value forests.

Ten per cent of the overall score calculated for each potential manager was based on their ESG capabilities and integration in a stand-alone section. However, ESG factors were also taken into account when scoring other areas, including the investment proposition, and the manager's track record and pipeline. Overall, therefore, ESG factors accounted for a considerable proportion of the total score. In addition, to be shortlisted and/or appointed, managers had to achieve minimum ESG standards set by EAPF.

Although a deep understanding of environmental risks is very important to EAPF, social and governance capabilities are also an important concern. This was therefore an area of particular focus during the due diligence process.

The prospective managers' ability to meet all of these requirements was tested stringently during several rounds of interviews, and they were expected to provide evidence backing up their claims. Finally, the requirements were embedded in the Investment Management Agreement with the selected manager.

1 Note that as a Local Government Pension Scheme the EAPF is bound by EU tendering rules. The Agency placed an advert in the Official Journal of the EU and followed the EU's public procurement processes.

CHALLENGES

Finding sufficient investment opportunities of the right size: Like many other large funds, EAPF has a minimum single mandate investment target. In this case, this is around £100 million (US$ 160 million). However, appropriate allocations to many environmental themed funds are much smaller – in the £10-50 million (US$ 16-80 million) range. This can be because they were established relatively recently or target quite small underlying investments. Even though their investment propositions may be of interest to EAPF, and the investment managers may be of high quality, EAPF is not able to consider them because it does not have sufficient resources to vet a large number of small opportunities. A managed portfolio of funds approach may be possible in some areas (such as real assets). In other areas by making clear its interest in environmental themed investing, and setting out its minimum requirements, EAPF hopes that it will encourage the development of this market segment and the number of suitable investment opportunities will grow.

Insufficiently proactive support from major investment consultants: in recent years, large investment consulting firms that support funds like EAPF have put considerable effort into developing responsible investment expertise and understanding the relevance of ESG issues to investment. Nevertheless, EAPF would like them to be more proactive and further improve their competence and services in this area. This could include embedding ESG and responsible investment across their businesses, putting greater focus on explaining to investors the value that good ESG management can add to investment mandates, and improving their rating systems for environmental and social themed funds. It also collaborates with other large pension funds to work with the investment consulting community to highlight the additional services they would like to be developed and the types of funds they would like to see.

All-round capability among environmental and social fund specialists is still evolving: As a leading responsible investor, committed to transparency, and seeking to invest in 'cutting-edge' environmental themed funds, EAPF places quite high demands on its managers. Not only do they need strong ESG capabilities, and good investment expertise, they also need robust back office functions, particularly management information and financial reporting systems, to provide the extensive performance data that EAPF requires. As noted above, because many providers of these funds were established relatively recently and/or are quite small, they can lack these capabilities. EAPF addresses this challenge by working collaboratively with them over time, to fulfil its requirements and setting clear goals and targets to help the managers develop these capabilities.

Decoupling long-term conviction and short-term investment decision-making: EAPF has a strong long-term conviction around sustainability and themes like clean technology. However, EAPF recognises that sectors based on robust long-term themes can falter in the short term. A good recent example is the solar industry, which has been hit hard by the poor global economic backdrop and changing dynamics in the energy sector. If they anticipate similar situations, managers need to have the confidence and discipline to reduce their exposure to, or divest altogether, from such themes – and their clients need to support them in doing so. EAPF now puts greater emphasis on discussing these types of scenarios with prospective managers and exploring how they would respond to them.