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ASH Briefing

Local authority pension funds and investments in the tobacco industry

February 2018

SMOKING PREVALENCE

This briefing is a position statement from Action on Smoking and Health and Share Action (formerly Fair Pensions).[1] It is intended to help inform stakeholders in local authority pensions, including Councillors, pension fund members, local taxpayers and pension fund trustees. It is intended to help them make decisions about their investment strategy, and in particular whether their pension fund should continue to invest in the tobacco industry.[2]

The Briefing argues that it can be lawful and reasonable for local authority pension funds to exclude tobacco-related stocks from their portfolio, provided the right process is followed to reach this decision, and the right factors are considered. Local authority pension funds should consider the financial factors that may make tobacco stocks a risky investment in the long term, and may also consider non-financial (e.g. ethical, social and environmental) factors provided that decisions based on such factors do not cause a financial detriments to the fund.

Examples of funds that have decided to exclude tobacco stocks from their portfolios include the Greater Manchester pension fund, currently the largest local authority fund in the UK.

EXAMPLE: GREATER MANCHESTER PENSION FUND

In September 2014 Greater Manchester Pension Fund considered a report recommending divestment from tobacco. The GMPF has now divested all of its directly held tobacco stocks. As the largest individual Local Government Pension Scheme fund, this move marks an historic first for the LGPS. The Treasurer to the Fund stated:

"The tobacco sector is relatively small as a proportion of World equity markets and the Fund's investment managers' views are that such exclusion is unlikely to have a material adverse impact on returns. If the Panel, in the future, decided to increase the number of sectors excluded, this would have a more material impact on returns and volatility."

FURTHER INFORMATION

ASH recommends the following sources for further information and advice:

• Tobacco Free Portfolios: which has produced an important Toolkit to guide pension funds considering their investment policy in relation to tobacco.[34]

• ShareAction: an NGO which campaigns for major institutional investors to adopt responsible Investment policies.

BACKGROUND

Most local authority pension funds invest in tobacco companies, the majority holding shares in the four major transnational tobacco companies, British American Tobacco, Imperial Tobacco Group, Japan Tobacco International and Philip Morris. In 2012 these direct investments were estimated to be valued at £1.7 billion, comprising 1.2% (range 0-3%) of aggregate fund valuations.[3] A recent analysis by the Guardian newspaper suggests that local authority pension funds still own at least £1 billion in tobacco industry shares, and that 28 local government pension schemes own a total of £700 million in shares in British American Tobacco alone.[4]

However, there is a fundamental contradiction between the duty of local authorities to promote public health[5] and the general wellbeing of local populations, and their investments in the tobacco industry, which manufactures products that remain the leading cause of preventable deaths in England and across the world, and which is implicated in serious environmental damage and unethical business practices, including child labour.[6] The purpose of this briefing is to examine how this contradiction might be resolved in the interests of public health, without breaching the duty of local authority pension fund trustees to ensure long-term financial returns for the funds' beneficiaries. Some local authority pension funds have already moved to reduce or eliminate investments in tobacco from their portfolios.[7] These pension funds have followed a careful process designed to show that not investing in tobacco does not breach their fiduciary duties.

When the issue of pension fund investments in tobacco is discussed, two key points are commonly made by local government officers and politicians who may be opposed to disinvestment:

1. Local authority pension funds have a legal duty to maximise financial returns from their investments

2. A rule barring a pension fund from investing in tobacco would increase financial risk by reducing the diversity of the fund's investments.

This briefing therefore sets out the law regarding the legal duties of local authority pension fund trustees, explains why excluding the tobacco industry from investment would not necessarily cause financial detriment to such funds, and sets out the options for trustees wishing to properly consider all concerns, both ethical and financial, around investments in the tobacco industry.

PROCESS

It is vitally important that a proper process is followed for reaching such a decision, based on the considerations set out in this paper. As a necessary first step, stakeholders wishing to consider an exclusion policy for their pension fund should be asking the following questions:

- Has your pension fund asked its fund managers for their view on the long-term financial viability of tobacco, specifically in light of declining markets and regulatory and litigation risks (which are all relevant financial factors in making investment decisions)? This should include an assessment of the likely long-term implications of: the WHO Framework Convention on Tobacco Control; regulatory trends in the UK and Europe (including successive tobacco control measures in the UK and the provisions of the revised EU Tobacco Products Directive); and other relevant international developments including the UN Sustainable Development Goals and their emphasis on non-communicable diseases, including those caused by tobacco consumption.

- Has your pension fund asked its fund managers to undertake an analysis of any anticipated long-term impact of excluding tobacco from their portfolio, taking into account any measures that could be taken to compensate for the exclusion (for example, increasing weightings of other stocks)?

- If not, will pension fund trustees:

  1. commission these analyses;

  2. make the results available to members; and

  3. review their tobacco holdings, taking into account these findings as well as the financial and non-financial concerns of members?

- Will the pension fund develop and publish a statement of policy in relation to investments in tobacco companies?

LEGAL DUTIES AND LOCAL AUTHORITY PENSION FUNDS

Trustees' legal obligations to pension fund members are known as fiduciary duties. The following section gives summaries of relevant UK regulations, previous case law and legal opinions on what these duties are and how they should be discharged. It will be seen that:

- Pension fund trustees should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and they can take a long term view when deciding on their investment strategies.
- Local authority pensions funds must publish a written statement of the principles underlying their decisions about investments
- Non-financial factors, including ethical considerations, may be taken into account in investment decisions provided they do not result in a financial detriment to the fund.

REGULATIONS

The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378):

- Statements of Investment Principles must include the extent (if at all) which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments. (Regulation 2(3)(b)(vi))
- Assets must be invested in the best interests of members and beneficiaries. (Regulation 4(2)(a))
- 'In the case of a potential conflict of interest (the assets must be invested) in the sole interest of members and beneficiaries'. (Regulation 4(2)(b))
- The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. (Regulation 4(3))
- The assets of the scheme must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and so as to avoid accumulations of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group must not expose the scheme to excessive risk concentration. (Regulation 4(7))

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (SI 2009/3093) in relation to ESG within Statements of Investment Principles:

- An administering authority must formulate a policy for the investment of its fund money, with a view to the advisability of investing fund money in a wide variety of investments; and to the suitability of particular investments and types of investments. (Regulation 11)
- An administering authority must, after consultation with such persons as it considers appropriate, prepare, maintain and publish a written statement of the principles governing its decisions about the investment of fund money. (Regulation 12). Persons to be consulted should certainly include Councillors.

In issuing these regulations, the Government did not seek to impose requirements regarding ethical investment. Instead the regulations require administering authorities to include in their statement of investment principles their policy on: *"the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments"*.

The Local Government Pension Scheme Regulations (SI 2013/ 2356):

- Administering authorities in the LGPS must publish a statement of their funding strategy and to publish an annual report assessing the performance of their investments against the strategy.

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (SI 2016/946):

- An administering authority must formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State. (Regulation 7). This must include:

    a) A requirement to invest money in a wide variety of investments;

    b) The authority's assessment of the suitability of particular investments and types of investments;

REGULATIONS (CONTINUED)

c) The authority's approach to risk, including the ways in which risks are to be measured and managed;

d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;

e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and

f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

The Investment Strategy Statement must also set out the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment. The Regulations apply to England and Wales only.

In October 2015, The Department of Communities and Local Government published a consultation on proposals to revoke and replace the LGPS Investment Regulations for England and Wales.[8]

This set out three main areas of reform:

- Removing some of the existing prescribed means of securing a diversified investment strategy and instead placing the onus on authorities to determine the balance of their investments and take account of risk.
- The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling of assets is adhered to. This includes a suggested power to intervene in the investment function of an administering authority when necessary.
- The introduction of statutory guidance to assist administering authorities prepare for the new Investment Strategy Statements, including specific guidance on the extent to which non-financial factors should be taken into account when making investment decisions and how these should reflect UK foreign policy

Criteria published alongside the consultation also made clear the Government's expectation for ambitious proposals for "pooling", whereby local authority pension funds would be merged, likely on regional lines.

New DCLG guidance was published on 15 September 2016. It says that administering authorities *"must commit to a suitable pool to achieve benefits of scale."*[9]

On taking social, environmental and corporate governance considerations into account, it says:

"The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise. However, the Government has made clear that using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government".

CASE LAW

In 1984, a court held in **Cowan v Scargill** that where the purpose of a trust is to provide financial benefits, powers of investment under the trust must be exercised 'so as to yield the best return for the beneficiaries', taking into account risks of the investments in question. The latter point frequently did not receive sufficient attention.

In Cowan v Scargill, the union trustees sought a blanket exclusion of all overseas investments, and of any industries in competition with coal. In a subsequent paper the judge speculated that a more nuanced policy – for example, of excluding certain investments 'all other things being equal' – might have been permissible.[10] More broadly, he suggested that an investment policy which accommodated the ethical concerns of some members without compromising the financial interests of others would be in the best interests of the beneficiaries as a whole. In other words, ethical criteria could be used to choose between two investment options that are equally attractive financially. This 'tie-break' principle has been restated several times in UK and US law and guidance.[11]

CASE LAW (CONTINUED)

A similar issue arose in **Martin v City of Edinburgh District Council** in 1988. A breach of trust arose since the Council divested from South Africa without expressly considering whether it was in the best interests of the beneficiaries, and without obtaining professional advice. However, the judge expressed the view that trustees did not in fact have an unqualified duty to 'rubber stamp' an investment manager's advice or to invest trust funds in the most profitable investment available.

In **Harries v Church Commissioners** (1992) the court held that excluding investments in certain business activities on ethical grounds could be acceptable where an adequate width of alternative investments remains, but trustees should not take into account such non-financial considerations to an extent which would give rise to risk of significant financial detriment.

After the Harries case, Lord Nicholls later wrote that: "the inclusion or exclusion of particular investments or types of investment will often be possible without incurring the risk of a lower rate of return or reducing the desirable spread of investments".

Local authority pension schemes (in line with other occupational pension schemes) are required to say in their Statement of Investment Principles *"the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments"*.[13] This provision was intended as a 'light-touch' intervention to clarify that it is indeed legitimate for pension funds to take ethical issues into account.[14]

In his judgement in **R (Palestine Solidarity Campaign) v Secretary of State for Communities and Local Government** (2017), Mr Justice Cranston wrote that:

"Certainly the case law recognises that non-financial factors can be pension purposes, as long as there is no risk of significant financial detriment from taking investment decisions with such factors into account".

LEGAL OPINIONS AND ADVICE

In October 2005, the law firm Freshfields Bruckhaus Deringer, commissioned by the United Nations Environment Programme Finance Initiative (UNEP FI) reported on the incorporation of environmental, social and governance (ESG) issues into investment risk analyses.[15] Freshfields argued that, no modern court would treat Cowan v Scargill as good authority for a binding rule that trustees must seek the maximum rate of return possible with every individual investment and ignore other considerations that may be of relevance, such as ESG considerations.

The report argued that pension fund trustees can fulfil their fiduciary duties provided they treat the purpose of the investment power (which for pension funds is to seek a financial return for the beneficiaries) as the primary purpose. Other considerations can be relevant, provided they do not override the primary purpose. Therefore, the consideration of secondary considerations, such as the public health case against tobacco investments, could legitimately form part of investment decision as long as they do not override the primary consideration of making a financial return.

The assessment of any individual investment should properly include its fit into the overall investment portfolio as well as its expected return. It is part of the trustee's role to seek returns across the entire portfolio in a variety of potential economic circumstances, rather than on an investment-by-investment basis.

On this basis, there are various reasons why trustees might conclude that tobacco is a risky long-term investment. For example, the London Borough of Newham currently excludes tobacco on this basis, saying in its Statement of Investment Principles:

"Fund managers are instructed not to invest segregated elements of their portfolio in companies that generate over half of their income from tobacco products, due to the risk that tobacco companies may face large liabilities from outstanding court actions."[16]

In March 2014, Nigel Giffin QC wrote an opinion for the Local Government Association, intended to answer the following questions:[17]

a. Does an administering authority owe a fiduciary duty and is to whom is it owed?

b. How should the wider functions, aims or objectives of the administering authority influence the discharge of its LGPS investment duties?

LEGAL OPINIONS AND ADVICE (CONTINUED)

Mr Giffin stated that: *"The administering authority's power of investment must be exercised for investment purposes, and not for any wider 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 (balancing risk and return in the normal way).*

However, so long as that remains true, the precise choice of investment may be influenced by wider social, ethical or environmental considerations, so long as that does not risk material financial detriment to the fund. 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)."

The consequence would be that an administering authority may choose to take into account the public health implications of investment, but only where the result of such considerations would not risk significant financial loss to the Fund.

FINANCIAL FACTORS

Pension fund trustees have a fiduciary duty to invest *"in the best interests of members and beneficiaries."*[18] This is based on the common law duty of loyalty, which exists to ensure that trustees avoid conflicts of interest and do not abuse their position to further their own ends.[19] Trustees also have a duty to invest prudently.[20]

Almost all pension funds now delegate day-to-day investment decision-making to external fund managers. However, this does not prevent them from instructing their fund managers in particular matters. **The law is quite clear that, although trustees may delegate their investment functions, they cannot delegate their fiduciary responsibilities.**

Trustees cannot be expected to predict actual investment performance. Therefore, the test of whether two options for investment were 'equivalent' is not outcome but process: did the trustees take appropriate advice, and, based on the information available at the time, was their decision reasonable? An appropriate decision to exclude tobacco from investment could pass this test. Many funds with much broader ethical exclusions (for example, the Norwegian State Pension Fund, which excludes investments in tobacco producers,[21] have consistently matched or outperformed the market. Although in general restricting the range of possible investments might increase the likely volatility of a portfolio (through reducing the security offered by diversification), the size of the tobacco industry in relation to the total stock market is small, and diversification might be protected by moving previous investments in the industry to other consumer (defensive) stocks.

Pension committees are typically given investment advice based on past performance of tobacco and other sectors, which in effect implies this will continue into the future. Typically this will be on 5 year time frames. However, the Law Commission report was clear that funds should be taking a long term perspective, and that past performance is no guide to future performance.

Final responsibility for investment decision-making rests with the trustees themselves. The judge in **Martin v City of Edinburgh** stressed that trustees must *"apply their minds separately and specifically to the question whether [the decision at hand] would be in the best interests of the beneficiaries."*[22] Moreover, in order to fulfil their fiduciary duties, the law requires trustees to monitor their fund managers on an ongoing basis.[23] In other words, as a FairPensions' report concluded, *"It is a vital principle of fiduciary obligation that fiduciaries cannot outsource their obligation to think."*[24]

Tobacco shares have traditionally been viewed as a low-risk, high profit investment. However, there are a number of factors suggesting that investments will be at risk in the medium and long term and there is a strong business case for reviewing investments in the short term.

FIRST: Sales in the UK, Europe and the United States have been in long-term decline and are predicted to decline further. Fewer than 1 in 5 (17%) adults in the United Kingdom now smoke: 19% of men and 15% of women. Smoking rates have more than halved since 1974 when 51% of men and 41% of women smoked.[25] During 2016, about 258 billion cigarettes were sold in the United States, a 2.5% decrease from the 264 billion sold in 2015, and the 640 billion sold in 1981.[26]

SECOND: This long-term decline is substantially a result of increasingly tight regulation of tobacco products. Although the tobacco industry is seeking to expand its sales in intermediate and low income countries, these countries are also introducing progressively tighter regulation in line with the provisions of the WHO Framework Convention on Tobacco Control. There are currently 181 Parties to the FCTC, including the UK Government.

FINANCIAL FACTORS (CONTINUED)

FCTC Article 5.3 states *"In setting and implementing their public health policies with respect to tobacco control, Parties shall act to protect these policies from commercial and other vested interests of the tobacco industry in accordance with national law."*

Guidelines for implementation of Article 5.3 were agreed at the third Conference of the Parties to the FCTC, in November 2008. Recommendation 4.7 of the guideline states that: *"Government institutions and their bodies should not have any financial interest in the tobacco industry, unless they are responsible for managing a Party's ownership interest in a State-owned tobacco industry".*

The FCTC's provisions also include price and tax measures to reduce the demand for tobacco products (Article 6), non-price measures to reduce demand (Article 7) product regulation (Article 9) packaging and labelling (Article 11), reducing advertising promotion and sponsorship (Article 13) and measures to reduce supply (Articles 15-17). The FCTC has the effect of encouraging countries to follow the example of global tobacco control leaders, therefore increasingly tight regulation across a wide range of countries is highly likely.

The European Union has introduced a revised Tobacco Products Directive, binding on all Member States which includes requirements for large pictorial and health warnings on cigarette and other tobacco packaging, and permits the introduction of the plain packaging of tobacco products.[27] Australia, France, the Republic of Ireland, Norway, New Zealand, Slovenia and the UK have introduced plain packaging legislation, and other countries are expected to follow.[28] Since plain packaging essentially removes brand identity (other than standard font brand names) from packs this policy is likely to have long-term consequences for sales.

THIRD: **In recent years Argentina, Israel, Italy, Turkey, France, Poland, India, Nigeria, Canadian provinces and Sri Lanka have all brought suits against tobacco companies relating to the healthcare costs arising from smoking. Lawyers in seventeen countries are currently following the lead of Dutch lawyers' in suing the tobacco industry for attempted murder or aggravated assault.**[29] It is reasonable to expect further initiatives of this kind in the future, particularly as the FCTC gains traction.

The damage to the tobacco industry from litigation is not limited to the cost of settlements alone. *"There is also a risk that, regardless of the outcome of the litigation, negative publicity from the litigation and other factors might make smoking less acceptable to the public, enhance public restrictions on smoking, induce many similar lawsuits against JT and its subsidiaries, forcing them to deal with and bear the costs of such lawsuits, and so on."* Japan Tobacco Inc, 2007[30]

These factors, together with the non-financial factors outlined below, have already driven an increasing number of insurers and pension funds to divest from tobacco. Tobacco Free Portfolios reports that in May 2016 AXA, one of the world's largest insurers, made a tobacco-free investment decision in May of that year, divesting €1.8 Billion of tobacco industry assets.[31] Further announcements in 2016 of obacco-free investment policies have been also announced by: AP4, one of the most influential pension funds in Sweden; Medibank, the largest health insurer in Australia; Fonds De Reserves Pour Les Retraites, France's sovereign pension reserve fund; the Irish Sovereign Investment Fund, and CalPERS, the largest public pension fund in the USA. To date in 2017, tobacco-free investment decisions have been made by AMP Capital, a global asset manager; Bank of New Zealand; SCOR, a global reinsurance company; PME, a large pension fund in Holland; Actiam, a large Dutch fund manager and Aviva, a global insurer and the largest insurer in the UK. In addition ABN AMRO, a global bank, has ceased lending to tobacco manufacturers.

THE UN SUSTAINABLE DEVELOPMENT GOALS

The UN Sustainable Development Goals (SDGs) were adopted by the UN General Assembly in September 2015.[32] There are seventeen Global Goals with targets. Goal 3 – Health and Wellbeing - has a specific target in relation to increasing the implementation of the WHO Framework Convention on Tobacco Control.

All countries are expected to consider the SDGs when preparing plans and policies for the next 15 years. The international community, including the United Nations, the World Bank and regional development banks, as well as public and private donors, is expected to assist governments to reach the SDGs.

Tobacco remains the single largest cause of premature deaths across the world. About half of all lifetime users will die of tobacco related disease. Across the world, more than 7 million people die from the consequences of tobacco use each year. More than 6 million of those deaths are the result of direct tobacco use while around 890 000 are the result of non-smokers being exposed to second-hand smoke. Nearly 80% of the world's more than 1 billion smokers now live in low- and middle-income countries.[33]

13 of the 17 Sustainable Development Goals are negatively impacted by tobacco. Examples include: Money spent on tobacco is money not spent on other household needs. In Thailand for example, low-income families spent 13.6 percent (5 times more than high income families) of their annual income on tobacco products, money that could be used for food, clothing and education. In Kenya and

THE UN SUSTAINABLE DEVELOPMENT GOALS (CONTINUED)

Bangladesh, tobacco cultivation has replaced food crops and has led to local food insecurity. In Malawi, at least 78,000 children are forced to work in tobacco fields, preventing most of them from attending school. In China, 53% of women of reproductive age are exposed to second-hand smoke at work, which raises the risk of complications in pregnancy. Tobacco growing is responsible across the world for biodiversity losses, land pollution through the use of pesticides, as well as soil degradation, deforestation and water pollution. Tobacco manufacturing is related to 30% of deforestation in Bangladesh.[34]

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