Responsible Investment: Review of current position and development of policy

Wales Pension Partnership

William Marshall,
Partner, Hymans Robertson

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HYMANS ROBERTSON

Agenda

- Introduction and executive summary
- Regulatory and current issues
- Summary of the Funds' positions
- WPP potential areas of focus

Introduction

- This note is addressed to the Joint Governance Committee ("JGC") of the Wales Pension Partnership ("WPP"). The purpose of this note is to consider how social, environmental and corporate governance considerations are taken into account by individual funds and at Pool level and to set out the actions the Pool should now take. It should not be released or otherwise disclosed to any third party except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have accepted such liability in writing.
- By placing an emphasis on long-term risks, the Pool will need to consider how Environmental, Social and Governance ("ESG") factors are taken into account within strategic decisions, as well as the existing focus on implementation, engagement, stewardship and monitoring. This can be encapsulated in WPP's approach to Responsible Investment.
- Responsible Investment can be broadly defined although we consider it has two elements: *Sustainable Investment* whereby the potential impact of ESG issues on financial outcomes are considered at each stage of the investment process and *Effective Stewardship* whereby investors ensure that they both place a value on and exercise the rights and responsibilities associated with asset ownership.
- This paper provides the following:
  - Review the eight Welsh Funds' responsible investment ("RI") and voting policies, highlighting areas of agreement and differences.
  - Discuss recent industry developments and areas for the Funds to consider when setting their future policies.
  - Set out potential next steps, which will be discussed at the Joint Governance Committee.
- We look forward to discussing this paper with you.

Executive summary of the Funds' positions

Fund	Bespoke RI Policy	LAPFF member	PRI signatory	UK SC signatory (3)	Investment Beliefs (4)	Voting	Explicit policy on Climate risk
Fund 1	✓	✓	✗	✗	✓	Delegated to managers	✓
Fund 2	✗	✓	✗	✗	Note 4	Delegated to managers	✗
Fund 3	Note 1	✓	✗	✗	✓	Delegated to managers	✗
Fund 4	✗	✓	✗	✗	✓	Delegated to managers	✗
Fund 5	✓	✓	✗	✓	✓	Delegated to managers	✗
Fund 6	Note 2	✓	✗	✗	Note 4	Delegated to managers	✓
Fund 7	✗	✓	✗	✗	Note 4	Delegated to managers	✗
Fund 8	Note 1	✓	✗	✓	✓	Delegated to managers	✗

1. Policy currently being drafted. 2. Fund has a RI statement on Climate Change in place. 3. All funds support the principles of the codes and expect their managers to be signatories. 4. Some Funds may have documented investment beliefs but these have not been made publically available.

Regulatory overview and current issues

Regulatory requirements/recommendations – a reminder

"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. Although schemes **should** make the pursuit of a financial return their predominant concern, they **may** also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision ." *MHCLG*

"The long-term investment interests of administering authorities are enhanced by the highest standards of corporate governance and corporate responsibility amongst the companies in which they invest. Poor governance can negatively impact shareholder value. Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper." *MHCLG*

"In formulating and maintaining their policy on social, environmental and corporate governance factors, an administering authority:- **Must** take proper advice; **Should** explain the extent to which the views of their local pension board and other interested parties who they consider may have an interest will be taken into account when making an investment decision based on non-financial factors; **Must** explain the extent to which non-financial factors will be taken into account in the selection, retention and realisation of investments; **Should** explain their approach to social investments." *Regulation 7 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016*.

Bolding added by Hymans Robertson for emphasis

Regulatory requirements/recommendations – a reminder

"Pool members **should** ensure that pool companies report in line with the SAB Code of Cost Transparency. They **should** also ensure that pool companies require their internal and external investment managers to do so. *Regulation 7 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016*."

"In formulating their policy on the exercise of rights, administering authorities: **Must** give reasons in their Investment Strategy Statement for not adopting a policy of exercising rights, including voting rights, attaching to investments; **Should**, where appropriate, explain their policy on stewardship with reference to the Stewardship Code; **Should** strongly encourage their fund managers, if any, to vote their company shares in line with their policy under Regulation 7(2)(f); **May** wish to appoint an independent proxy voting agent to exercise their proxy voting and monitor the voting activity of the managers, if any, and for reports on voting activity to be submitted annually to the administering authority; **Should** publish a report of voting activity as part of their pension fund annual report under Regulation 57 of the 2013 Regulations. *Regulation 7 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016*."

Well-being of Future Generations (Wales) Act 2015

"The Act will make the public bodies listed in the Act think more about the long term, work better with people and communities and each other, look to prevent problems and take a more joined-up approach. This new law will mean that, for the first time, public bodies listed in the Act must do what they do in a sustainable way. Public bodies need to make sure that when making their decisions they take into account the impact they could have on people living their lives in Wales in the future."

Bolding added by Hymans Robertson for emphasis

Other developments to consider

FRC UK Stewardship Code.

It is currently expected that the FRC will publish a consultation on the Stewardship Code on 30 January 2019 with a revised Code expected to be introduced around July 2019. As potential signatories, WPP may wish to review the consultation.

Climate risk.

There is increasing scrutiny on the actions being taken by long-term institutional investors in addressing the risks associated with climate change. We set out overleaf some of the major regulatory considerations over recent times suggesting this should be an issue which is explicitly addressed in WPP's RI policy.

Recommendations of the Task Force on Climate-related Financial Disclosures ("TCFD"). The TCFD has proposed a framework within which institutions can report on their approach to climate change. Individual Funds may come under pressure to report in line with the TCFD recommendations and WPP may wish to consider how they can support such Funds.

What are the regulators saying about climate risk?

- Guidance from the **Pensions Regulator** states that climate change is a risk that 'could be financially significant both over the short term and the longer term'. They also tell trustees to **take climate risk factors into account** when making investment decisions and encourage them to become familiar with their managers' stewardship policies.
- The **Environmental Audit Committee** (EAC) recently stated that MPs want to see pension savers be given greater opportunities to engage with decisions about where their money is invested. Mary Creagh MP, Chair of the EAC said, "**We want to see mandatory climate risk reporting** and a clarification in law that pension trustees have a duty to consider long term sustainability, not just short-term returns."
- Following the Department for Work and Pensions' (DWP's) consultation on changes to occupational pension scheme regulations, from 1 October 2019 trustees will be required to set out in their Statement of Investment Principles **how they take account of financially material considerations and stewardship, including climate change**.
- The **Institute and Faculty of Actuaries** released a Risk Alert stating that actuaries should ensure that they understand and are clear in communicating the **extent to which they have taken account of climate-related risks** in any relevant decisions, calculations or advice.

In light of the emerging consensus about the financial materiality of climate risk, regulators are now encouraging asset owners to seriously consider the impact of climate-related risks and opportunities on their pension schemes

Summary of the Funds' positions

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Observations on the current arrangements

- There are several areas of commonality in that:
  - Voting policy is delegated to investment managers;
  - All funds are members of LAPFF, but unclear how Funds interact with LAPFF;
  - Majority are not signatories of the UK Stewardship Code or UNPRI;
  - Not clear how much reporting each fund receives on ESG issues from their managers.
- One fund is not clear on the financial materiality of ESG factors;
- Several funds have undertaken some action to explicitly address RI issues. In particular, actions that have been taken include:
  - Several funds have worked to develop their own investment beliefs;
  - One fund has undertaken a carbon footprinting exercise and introduced a target to reduce its carbon exposure. One other fund has made a statement of its position on climate change;
  - Two funds are signatories to the UK Stewardship Code;
  - Several funds are in the process of completing RI policies

WPP potential areas of focus

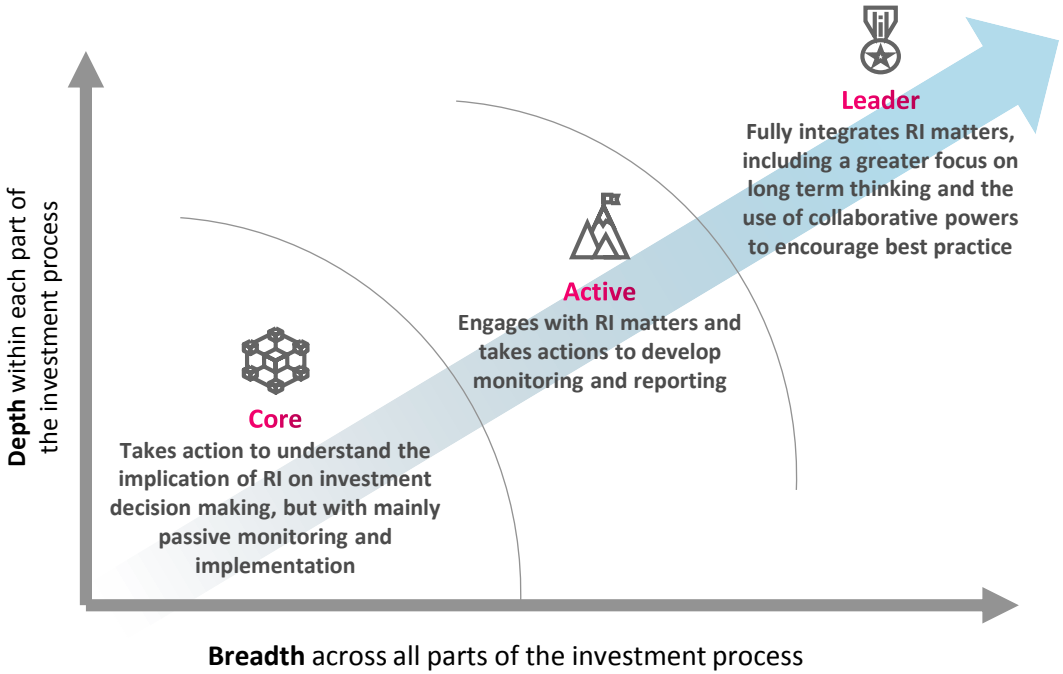
A key question for WPP and the Funds is to consider "what sort of responsible investors they want to be"

There is a spectrum of positions that the pool could take on RI although the position they choose to take should be both proportionate and scheme specific, informed by a number of factors. These factors include:

- Views and investment beliefs;
- The investment time horizon;
- Asset size and the associated complexity of the investment arrangements;
- The means of implementation;
- The overall governance budget;
- Potential scrutiny of the investment arrangements.

To help inform officers discussions, we have developed a framework within which the Pool can consider the position they wish to take

This framework is not intended to be rigid and there may be some elements for which a higher (or lower) level of behaviour is deemed appropriate.



Core position criteria (1)

RI Criteria	Comment on potential actions for WPP to develop RI policy
Beliefs	Several, but not all Funds have developed beliefs. WPP could consider consolidating beliefs at a pool level to reflect common thinking. Still allows Funds to have their own beliefs but should seek to be complementary.
Policies	WPP to consider whether it is appropriate for Stewardship activity (voting and engagement) should continue to be delegated to investment managers or whether to adopt a Pool level policy. Propose developing a pool level policy. Consider a definition of RI that is applicable to the Pool and Funds. WPP to enforce requirements on Cost Transparency.
Training	WPP to consider how it can support education both within the Pool and to Funds.
Strategy	WPP should seek input from Funds on how It can support their strategy requirements.
Structure	WPP should seek input from Funds on how It can support their strategy requirements. Consideration can be given to the introduction of sub-funds that have defined sustainability criteria.

Core position criteria (2)

RI Criteria	Comment on potential actions to develop RI policy
Manager selection/ appointment	For certain sub-funds funds, WPP has delegated responsibility for the consideration of RI criteria to Russell Investments (initial fund Global Opportunities). WPP should consider any minimum criteria it wishes to reflect in manager selection and agree these with Russell.
Reporting	WPP can consider what metrics it is important to demand be reported by its providers and dictate the format of reporting. WPP needs to ensure that sufficient information is available to fulfil reporting needs e.g. footprinting. WPP to consider its own disclosures and those of Funds and explore how Funds needs are met.
Monitoring	WPP to consider approach to ensuring that managers are meeting policies. What challenge mechanisms exist to ensure that reporting is acted upon. Is there an appropriate governance framework in place.
Adherence	WPP should ensure that it reviews compliance with its own policies.

WPP comparison of RI beliefs

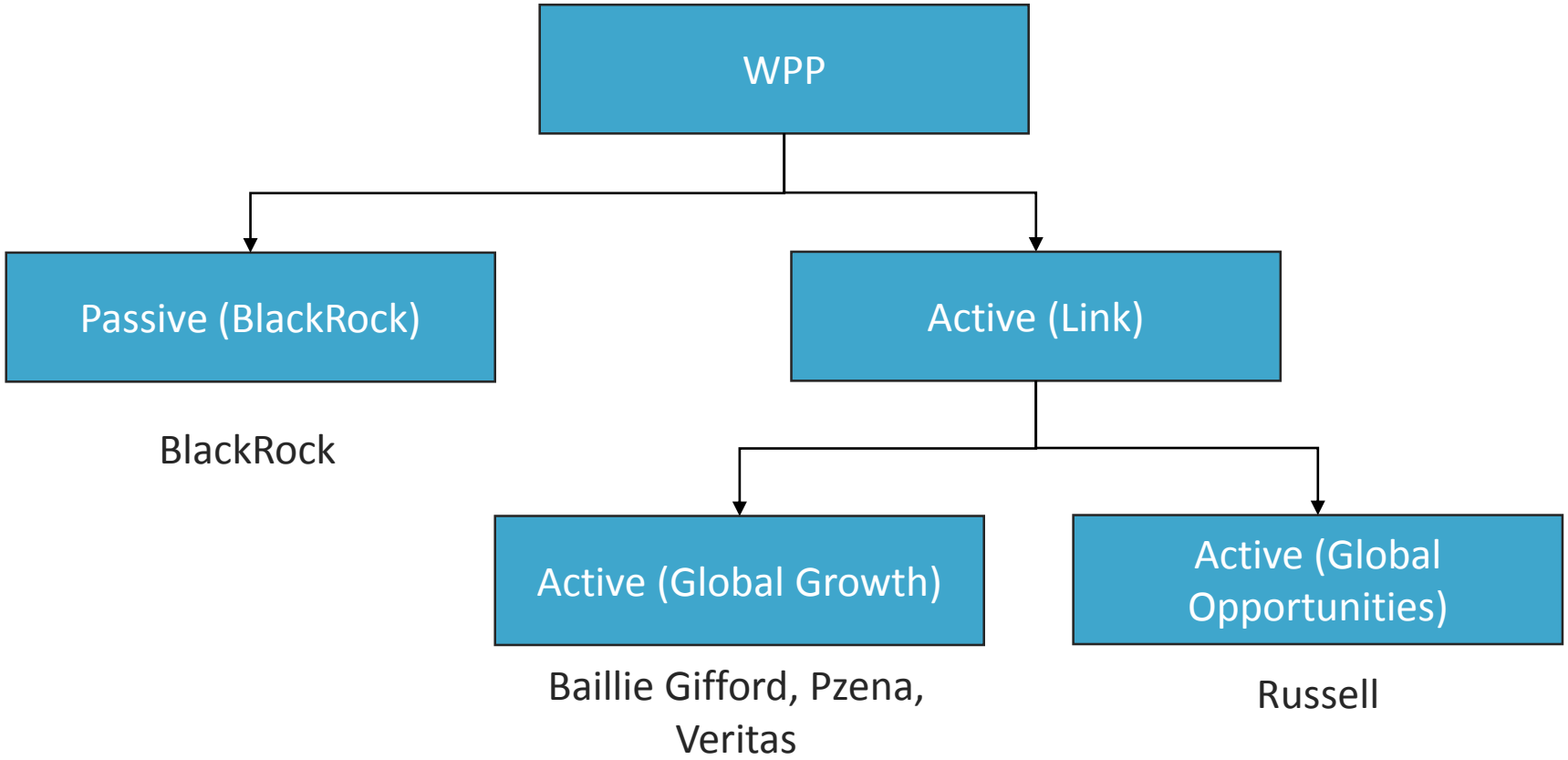
- In the table below we have provided some examples of common areas across the responsible investment beliefs of the funds for which the information was available.
- Further work will be required to establish a set of beliefs and practices that all Funds will subscribe

Areas of Commonality	Observations relating to the Beliefs
Clarity and transparency of the Fund's approach	The Funds should develop a formal responsible investment policy for the Fund. The Funds should publicly disclose its activity on ESG and Stewardship to all stakeholders.
Fully integrated into managers' processes	The Funds' investment managers should embed the consideration of ESG factors into their investment process and decision making.
More information and better reporting	More information is needed to determine the potential financial risk to the Funds of climate change. The Funds would benefit from greater reporting on ESG factors as part of its ongoing monitoring activities.
Engagement with managers where possible	The Funds need to engage more with the Fund's investment managers to better understand ESG risks.

WPP management of climate risk

- Range of approaches amongst the 8 Funds to address this with one fund having set an explicit carbon target.
- The role of the Pool is to facilitate the strategic actions that the Funds may wish to take, but the Pool can support these actions through its RI policy and activities.
- For example, the Pool may have a policy of pushing managers to improve disclosure on climate risk or to vote in favour of climate related resolutions.
- Further, the Pool can lend its support to collaborative actions on behalf of the funds.
- Funds influence sub-fund offering

WPP - which voting policy applies, e.g. Global Equity



WPP voting arrangements

- The current approach to the implementation of voting policy has the potential for inconsistency.
- For active equity funds, Link has set out voting guidelines which are then implemented by the respective managers, subject to a comply or explain approach.
- Managers could interpret the guidelines differently or exercise a different view and hence the possibility remains that managers could vote differently on the same share.
- For passive funds, the voting policy is both framed and implemented by BlackRock.
- There is reporting obligation on Link to WPP, but equally a reporting obligation from each of the underlying managers to Link. This could create operational inconsistencies or delays although the use of a single custodian should limit this.
- Whilst Link has proposed and implemented the voting guidelines to WPP, has there been consultation with WPP on the appropriateness of these guidelines? Has there been any dialogue between Link and the managers on the interpretation of the guidelines?

WPP voting and engagement comments

- Potential areas for discussion and action:
  - Engagement with Link on the voting guidelines to ensure that they are fit for purpose and meet WPP's requirements;
  - Engagement with Link on the reporting requirements and scrutiny of voting;
  - Review consistency of approach between active and passive management and agree how to hold BlackRock to account;
  - Consider
    - potential to use a single voting agent rather than delegating voting to individual managers. This could be a proxy adviser (e.g. ISS) or a third party (e.g. Hermes)
    - If there is flexibility within BlackRock's approach
    - interaction of voting and engagement and whether engagement could be implemented separately. Explore role of LAPFF.
    - Other forms of joint engagement e.g. IIGCC

Goals in the development of RI policy for WPP

For the development of a RI policy, the following criteria are suggested:

- **Clear** – Policy should be unambiguous, particularly under external scrutiny.
- **Proportionate** – Policy should reflect where the Funds and WPP are at in their RI journey. There is no need to try to become a Leader overnight.
- **Consistent** – Policy should reflect the decisions that have already be taken both within WPP and, as far as possible, the Funds.
- **Implementable** – Policy should be able to be put into practice using the structure and resources of the Pool.
- **Reflective of best practice** – Policy should consider current regulatory and best practice requirements but be subject to review and change in future.

WPP - what issues should you include in your policy?

Area	Issues to cover
Policy/Governance	Beliefs Education Divestment Fund engagement Approach to review of policy Delegations
Strategy/Structure	Climate risk Approach to different asset classes
Implementation	Approach to manager selection Fees/costs and transparency
Stewardship	Voting policies and approach to voting Engagement with companies Collaboration Litigation
Monitoring	Information/reporting requirements of third parties Approach to reviewing adherence to policy Disclosure/transparency

Potential next steps

- Discussion with Link and BlackRock on practicalities of current voting and engagement arrangements (March 2019 OWG)
- Initial framework for RI policy (March 2019 OWG)
  - WPP to consider how they want to define “Responsible Investment”
  - Issue short questionnaire to Funds to help develop WPP RI beliefs and policy (January/February 2019)
- Draft RI policy for review by WPP and agreement with Funds (27 March 2019 JGC)
- Consider potential next steps e.g. explicit policies on certain topics subjects (27 March 2019 JGC)

Appendix 1

Industry codes

UK Stewardship Code

Currently 31 LGPS funds and 3 pools are listed as signatories to the Code

MHCLG guidance suggests that Funds should become signatories to the Code

To become a signatory, entities have to produce a statement detailing how they comply with each of the principles. There is no cost.

The Code is due to be reviewed during 2019

The Principles of the Code

So as to protect and enhance the value that accrues to the ultimate beneficiary, institutional investors should:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.
3. monitor their investee companies.
4. establish clear guidelines on when and how they will escalate their stewardship activities.
5. be willing to act collectively with other investors where appropriate.
6. have a clear policy on voting and disclosure of voting activity.
7. report periodically on their stewardship and voting activities.

Principles for Responsible Investment

Currently 10 LGPS funds and 4 pools are listed as signatories to the PRI

Signing up to the PRI places an obligation on entities that they will commit to complying with the principles, and to reporting how they comply

There is a cost to signing of circa £10k per annum

Signatories' commitment

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time).

We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress towards implementing the Principles.

Thank you

This paper is addressed to the JGC of the Wales Pension Partnership ("WPP"). The purpose of this paper is to provide a summary of the Funds' positions on ESG related matters and potential areas for future consideration. The note has not been prepared for use for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent.

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