Geik Drever
Director of Pensions

West Midlands Pension Fund
PO Box 3948
Wolverhampton
WV1 1XP
t: 0300 111 1665
e: pensionfundenquiries@wolverhampton.gov.uk
w: wmpfonline.com
@wmpfonline

(01902) 552020

FAO:
REINVIGORATING.PENSIONS@DWP.GSI.GOV.UK

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Dear Sir or Madam

RE. Changes to Investment Management Regulations: Embedding Responsible Investment Practice by Trustees

We welcome the opportunity to respond to the Department of Work and Pension's (DWP) consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'.

West Midlands Pension Fund (the Fund) provides pension services to over 277,000 current and former employees of the seven West Midlands district councils and over 450 employers participating in the Fund. It is one of the largest funds in England and Wales, employing 116 FTE members of staff and as at 31st March 2015 the Fund was valued at over £11 billion.

The Fund believes our fiduciary duty to act in the best the long-term interest of our members; and to do so, requires us to recognize that environmental, social and governance issues (ESG) can adversely impact on the Fund's long term financial performance and should be taken into account in our investment approach. Our Responsible Investment beliefs as agreed by Pensions Committee in December 2014 are attached to this submission.

The Fund is pleased with the recent clarification by the Law Commission that material ESG factors that pose risks to the long term sustainability of a company are classified as financial factors. By extension, this means that financially material ESG issues should be taken into account by trustees as part of their fiduciary duty. It is now clear that many ESG factors have financial consequences over time and impact both positively and negatively on the value of, and the risk/return ratio of an individual or portfolio of investment assets. Some ESG factors may be difficult for trustees and their officers to quantify in terms of their impact on investment return, but may nevertheless raise impacts on reputational risk for a fund, and its trustees, or policy factors that have adverse stakeholder impacts where appropriate action by trustees may be required, mitigated by the perceived adverse financial impact on a fund's sustainable investment returns. The Fund would therefore recommend the DWP lead an initiative in the promotion of the Law Commission trustee guidance1 in aid of clarifying many misconceptions that exist in this agenda, as highlighted in the Fund's response.

[1] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf

The Fund has answered the specific questions raised in the consultation below and would welcome a further conversation with the DWP as its thinking develops in this area.

Yours sincerely

Mark Chaloner
Assistant Director (Investments)
West Midlands Pension Fund
responsibleinvestment@wolverhampton.gov.uk

24 April 2015

Consultation Questions:

Question 1 How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

Vagueness and misuse of terminology has undermined the ability of trustees to consider, with confidence, a broader spectrum of risks, particularly long term risks, within funding and investment decision making. We believe that clarifying the distinction between financial and non-financial factors is important, but needs very careful consideration as it is often the motivation in the consideration of the factor, rather than the factor itself, that determines whether it is financial or non-financial. The Law Commission itself eloquently illustrates this in their guidance looking at the issue of tobacco.

We believe that strict labelling of certain types of factors as "financial" and others as "non-financial" is not appropriate. We believe the guidance should focus on the process of evaluation, discussion and judgement behind the integration of a wide-range of factors in investment decision-making.

As previously stated, the Fund was pleased with the clarification from the Law Commission that material ESG factors that pose risks to the long term sustainability of company are classified as financial factors. Guidance and support is needed to help trustees in the consideration of these factors, when it is not always possible to be quantitative and or where these risks might materialise over a longer time horizon.

The Law Commission should therefore make sure that there is no misconception: if ESG factors can influence long-term value and if engagement with companies can help to reduce long-term risk and increase value, then trustees overall have a fiduciary obligation to take ESG factors into account and disclose how they are doing so. More specifically, the Fund is of the view that trustees should take these issues into account where material rather than, as the consultation suggests, being able to decide whether to take them into account or not.

Clear communications to the beneficiaries about how their trustees consider such risks in their funding and investment processes, including exercise of stewardship activities, are essential. We believe that such transparency extends beyond principles and policy statements, but an annual implementation statement should be included in the annual report and financial statements.

While trustees might find it difficult to assess ESG factors and then make the right decisions taking these factors into account, there is an increasing body of evidence to demonstrate not only that they have a bearing on financial performance but that some activities, including active stewardship, can positively influence long-term risk adjusted returns. In our view this is best implemented by a combination of integration of ESG factors as part of the investment process and through active stewardship of portfolio companies and assets. To support this process, there are numerous existing sources at the trustees' disposal including the Principles for Responsible Investment (PRI), UKSIF, ShareAction, Institutional Investor Group on Climate Change, to name but a few. Any clarification in regulation should support the requirement for trustees to familiarize themselves with the materiality of these issues (e.g through explanatory notes or other guidance).
For the Fund's response to updating the language the Statement of Investment Principles (SIP) as highlighted in the Law Commission findings, please refer to the response to Question 2 below.

Question 2 Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation? If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?

One example of misused terminology is the term "stewardship". Stewardship is engagement with companies, fund managers or other investment actors as a tool to enhance risk-adjusted returns. Engagement activities may include monitoring and engaging with said investment actors on matters such as culture, strategy, performance, risk, capital structure, ESG issues and alleged violations of securities laws (shareholder litigation). It has a much broader remit than voting and company engagement on ESG issues. It is important that any trustee guidance clarifies the definition of stewardship in this regard.

The Fund sympathises with the previously stated position of the Law Commission that "any attempt to change fiduciary duty through legislation would result in new uncertainties and could have unintended consequences". However as previously stated, it is important to provide more guidance on the interpretation of the general law of fiduciary duties such that these are consistent with the aim of promoting behaviours aligned to pension funds' long-term investment horizons, and to limit the flexibility allowed within the scope of fiduciary duties that may unintentionally contribute to enabling the persistence of potentially harmful behaviours.

With the above complexities in mind, the Fund is not supportive of including compliance with the Stewardship Code in its current format for the reasons stated in the first section below. However, the Fund is supportive of more updated language in the SIP to account for wider stewardship issues, as further explained in the second section below.

Stewardship Code not fit for purpose for asset owners

We note that in many ways the structure and wording of the current Stewardship Code[2]. is geared towards the specific activities and responsibilities of asset managers, which vary from those of pension fund trustees as asset owners. Thus, we are reticent about supporting the current proposal as we feel asking asset owners to "comply or explain" with the Stewardship Code in its current form may risk a compliance, "box-ticking" approach resulting in undue confusion as to what trustees' responsibilities are. As a result, they would still not be addressing their fiduciary duty as defined by the Law Commission.

The above paradigm has resulted in the following unintended but negative consequences of the Code, amongst others:

- In some of the corporate risk registers of pension schemes, the Fund has observed that the "ESG" or "stewardship" section falls within the Compliance and not the Investment section of the risk register. This may support the broader view that ESG/stewardship is viewed as a compliance or "box-ticking" exercise and not connected to investment risk or opportunity.

- Anecdotal feedback suggests of many asset owners do not see any applicability of the Stewardship Code to them, but as something their asset managers do. In the Fund's view,

[2] Note that the Fund will seek to set out its concerns in these areas and potential solutions, as part of the next proposed consultation on the Code by the Financial Reporting Council at the appropriate time.

an asset owner who delegates stewardship activities to a third party (whether it be a provider or the fund manager, or both), without also demonstrating robust oversight, monitoring and reporting, is not complying with the spirit of the Code.

Note that while the Fund does not recommend the inclusion of the Stewardship Code into investment management regulations in such a way, this does not preclude any pension fund trustee from using the Code and/or any other principles-based framework[3] to advance its own understanding of how its investment managers are giving due consideration to ESG issues and more broadly, how they are being effective stewards of the Fund's assets. As some trustees reportedly do not understand the Code's relevance to their duty, further clarification in this area is required.

We would also encourage the DWP to promote the value of asset owners working in collaboration, which is very different from 'acting in concert', the misconception of which has also hindered some trustees. The importance and impact of asset owners sending a consistent aligned signal to the market as to what it expects of various investment actors (investment managers, companies, consultants etc) on RI related matters should not be underestimated. An example of this is the recently launched Guide to Responsible Investment in Public Equity[4] – an important investor coalition effort of which the Fund was a deputy editor and key participant.

Statement of stewardship/RI approach in SIP

The Law Commission previously recommended that trustees should be encouraged to consider whether and how to carry out their stewardship responsibilities – engagement with investee companies and exercising of voting rights - either directly or through their investment managers. The report recommended including a specific requirement for the fund's SIP to contain a statement of the trustees' policy on stewardship. To this question we are very supportive of updating the current language[5] as suggested by requiring trustees include a statement within the SIP on their policy on stewardship which should contain:

- How they directly or indirectly evaluate longer-term risks, including from ESG and other factors, which may become financially material to the performance of their investments
- The extent (if at all) to which they may consider making investment decisions on the basis of non-financial factors
- How the Fund either directly approaches its stewardship responsibilities or oversees how stewardships activities are applied by external fund managers across all asset classes and in all markets in which the scheme invests.

If the pension fund in question does not have a stewardship policy, they should state so and why.

Concluding remarks

Whilst we recognize that there are certain policies and procedures that would need to underpin a pension fund's ability to be able to adequately address its stewardship responsibilities, the Fund does not feel that those requirements should be embedded into a legal framework, due to concerns already raised. The pension fund ought to develop an RI approach that is suitable to their

[3] E.g., Principles for Responsible Investment

[4]http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0424_guide_to_responsible_investment_reporting_in_public_equity_published.aspx

[5] Social, ethical and environmental considerations (SEE)

respective investment beliefs, governance structures, available resources, and other considerations. The legal framework should support the "destination" of the pension fund in question regarding RI (e.g., improved risk-adjusted returns, norms-based screening), but not overly prescribe the "journey".

The Fund feels that the focus should be on clarifying the existing regulations to address the misconceptions in this space (e.g., through explanatory notes), to allow space for more market-driven solutions.

Question 3- What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2? What, if any, costs would be involved in meeting any new requirements?

There are minimal costs to trustees in considering how ESG factors might be incorporated into their funds' decision making process and how stewardship activities could be undertaken. The current framework that the trustees currently operate under should be sufficient. In addition, there are a number of organisations as well as other asset owners who would be prepared to support trustees in this consideration at no or very little cost.

Costs have the potential to be incurred during implementation; the level of which depends on the approach taken. In practice, this can take several different forms from developing a specialised in-house resource to deploy the fund's ESG integration and stewardship work, to outsourcing these responsibilities to third party service providers on a full time basis, to simply retaining the services of consultants on an ad-hoc basis.