Appendix 2

Project Proposal for Fundamental Review of SIP in relation to Responsible Ownership

1. Executive Summary

1.1 The purpose of this note is set out a proposal for a project to conduct a fundamental review of MPF's approach to Responsible Ownership as described in its SIP, in particular the merits of the strategies of engagement and screening.

1.2 Members are asked to approve the commencement of this project and to indicate any changes they wish to make to the project brief.

1.3 This note will cover the following; Background, Workstream projects including: Objectives/Philosophical Beliefs; Legal Framework; Practical Implications; and Performance Implications.

2. Background

2.1 There has been significant debate of late over whether the Fund should be invested in certain companies/sectors. In terms of the responsible ownership element of the SIP this is best considered as a debate between the strategies of engagement and screening both positive and negative. The definitions of these are listed below.

Responsible Investment, in theory and practice, continues to develop around three broadly defined strategies. These strategies have found favour with different groups of investor, at different times, responding to different objectives, but also to changing market conditions (both in terms of investor sentiment and market infrastructure e.g. scope and availability of data). These strategies are:

1. *Negative screening* - A screen is applied across a portfolio that will exclude certain stocks that exhibit any of a set of pre-determined characteristics. This is the method commonly used for implementing ethical investment, whereby an investor may determine a set of ethical criteria on which they would want a stock excluded from their portfolio. Typically, this approach would be adopted by what could be broadly termed 'mission based investors', such as charities, religious institutions, trade unions and endowments, whose main objectives and activities could be in direct conflict with those of certain companies. Exclusion criteria commonly cover companies who derive at least 10% of their revenues from activities in one or more of the following: armaments, gambling, nuclear power/uranium extraction, tobacco, questionable work-place practices, any particularly egregious ESG practices. In addition to being in

conflict with an investor's values or ethos, the argument made from the perspective of a long-term investor is that companies with these characteristics carry long-term risk factors such reputational risk, Government regulation, litigation and an overall higher cost of capital.

2. *Positive screening* - This practice applies a screen across a porfolio that gives preference to stocks or sectors exhibiting certain characteristics. This can make use of specialist data-sets such as indices (e.g. FTSE4Good) or ratings (e.g. PIRC Governance ratings). It can also be used to implement a theme-driven approach, such as over-weighting portfolios in favour of stocks with strong sustainability or governance characteristics.

3. *ESG integration and engagement* - This approach does not involve top-down imposition of investment rules, but flows from an investor's strategic RI beliefs and objectives. It is a holistic approach ranging from integration of ESG factors into investment analysis and decision-making to active ownership activity (usually incorporating voting and engagement). It is the approach most commonly adopted by large institutional investors who recognise that effectively they 'own the market' and costs which are externalised will fall to them. An investor adopting this approach would typically establish guidelines determining the extent of ESG integration and setting out ESG priorities, which would determine active ownership activities. Applying the 6 Principles of the UN PRI is commonly seen as a good way of implementing this approach, not least because UN PRI require compulsory reporting and assessment of its signatories, which allows the RI investor to monitor and review their activity, as well as benchmark against peers.

2.2 The Responsible Ownership section of the SIP at present is based on a strategy of engagement. The key aim of this project would be to consider whether this is still appropriate and to consider the use of screening both positive and negative. If taken forward, the second stage would be to consider policy options for screening and to examine the implications for these options in terms of legality, practicality,costs and performance.

3. Workstream 1: Objectives/Philosophical Beliefs

3.1 The purpose of this workstream would be to establish the views of Committee on certain issues and to draw out themes. The main event would be an IMWP/Member Development Session. In February of next year.

3.2 The internal team at MPF would look to provide reading material to Members ahead of this session. During the session there would be external speakers to further elucidate the options available.

3.3 Following the session in February, officers would look to draw in ideas expressed by Members and subject to legal opinion, draw up a number of policy options to be considered in terms of how practical they are to implement and what is the likely impact on investment performance.

3.4 These policy options could include various forms of positive or negative screening in certain markets/sectors

4. Workstream 2: Legal Framework

4.1 The LGPS is a statutory scheme and the investment powers of the Administering Authority flow from the LGPS Investment Regulations. The Regulations provide that schemes must formulate an investment policy, based on proper advice and with regard to the suitability and advisability of particular investments. The policy should also state the extent to which 'social, environmental or ethical considerations are taken into account'. The Regulations imply, but do not stipulate, that in formulating this policy an Administering Authority should have regard to its fiduciary duty.

4.2 A fiduciary is someone with the obligation to act in the interests of others. However, its precise definition in law is unclear, as it the legal basis for its application in the context of pension funds investment. The traditional view has been that the fiduciary duty lies in the optimisation of returns on pension fund investments. However, an influential QC's opinion published as the 2005 Freshfield Report, argued that the growing acceptance that ESG factors could have a material impact on long-term investment returns meant that it could be a breach of fiduciary to not include ESG considerations in determining investment policy.

4.3 The UK Government have tasked the Law Commission to carry out a through-going review of fiduciary duty as it is currently understood, to determine if it contributes to the short-termism in investment practice, as criticised in the Kay Review. The Law Commission have issued a comprehensive Consultation Paper, which sets out the law as it stands, highlights some areas of contradiction or confusion and invites comments as to how the law could be clarified. They expect to report back to Government in June 2014.

4.4 The LGPS Advisory Board will be participating in this consultation, with a view to assessing implications for the LGPS and the need for future amendments to the Regulations. This workstream will need to have regard to the Law Commission's paper, its relevance to the LGPS and the likelihood of post-2014 changes to the LGPS Regulations.

4.5 This workstream will involve officers conducting research and presenting to Members on the above issues

5. Workstream 3: Practical Implications

5.1 This work stream would involve fund officers looking at the practical implications of policy options. Issues involved would be:

- Use of pooled funds both private and public equities and fixed income instruments - how can MPF influence policy in these funds?
- Fee implications for changing mandates particularly in passive arrangements.
- Cost of disinvestment from existing investments particularly in pooled vehicles.
- How policy options affect fixed income investments.

6 Workstream 4: Performance Implications

6.1 The aim of this work stream would be to look at the likely impact of policy options on investment performance. Whilst past performance is not a guide to future performance it is an indicator of magnitude and a significant part of the modelling will include backward testing of options. Officers will also look to external sources to assist with models looking to future investment performance.

6.2 This work would take place between the first and second sessions with Members of Pensions Committee at the IMWP/ Member Development meetings.

6.3 This could entail use of external consulting resources to conduct the modelling.

7 Timetable

7.1 This is a significant piece of work and there is a need to bring the workstreams together in a coherent way and to ensure that the inputs have been discussed by the Members of Pensions Committee and other working parties. The timetable for the project is linked to these meetings and the need for considerable work in between.

7.2 The suggested timetable is below.

November 2013 – February 2014

Preparation for IMWP/Member Development in February

Work by officers on workstreams 1 and 2 including preparation of documents for session and engagement of external speakers clarification of legal position

TBC February IMWP/Member Development Session

Completion of workstream 1
Draft policy options agreed for detailed work by officers on implications

February 2014 – May 2014

Detailed work by officers on workstreams 3 and 4

TBC May 2014 IMWP/Member Development Session

Presentation of results of workstreams 2,3,4
Final agreement of policy options

TBC June 2014 Revised SIP to Pensions Committee

8. Outcomes

8.1 The ultimate outcome of the process would be a report encompassing the results of the different workstreams and a recommendation for an update to the Responsible Ownership section in the SIP. This could be taken to a Pensions Committee in June 2014.