



PENSIONS COMMITTEE

9 DECEMBER 2024

REPORT TITLE:	UPDATE ON INVESTMENTS IN DEFENCE COMPANIES
REPORT OF:	DIRECTOR OF PENSIONS

REPORT SUMMARY

This report provides Members with a summary of deliberations at recent Responsible Investment Working Parties and Investment Monitoring Working Parties and recommends that Merseyside Pension Fund (MPF) should ensure that it does not hold investments in companies which manufacture weapons proscribed by international treaty to which the UK government is a signatory.

RECOMMENDATION/S

That the Pensions Committee be recommended to mandate to the effect that Merseyside Pension Fund should not hold investments in companies which manufacture weapons proscribed by international treaty to which the UK government is a signatory.

SUPPORTING INFORMATION

1.0 REASON FOR RECOMMENDATION

- 1.1 Government guidance sets out that 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. Having considered a range of exclusion scenarios, it is recognised that the diversity of opinion on this subject makes it very difficult for Members to have good reason to assume that scheme members would support a specific course of action other than that established by government. The most appropriate action, bearing in mind the various considerations discussed at the working parties and summarised in this report, is to be guided by government policy and advice.

2.0 OTHER OPTIONS CONSIDERED

- 2.1 Members reviewed a number of approaches adopted by other funds and index providers to assess whether there are market norms that MPF might consider. The analysis reveals a lack of consistency of approach even amongst peers and funds that use exclusion as one of their key levers and are considered by some to be particularly advanced in ethical investment thinking.

3.0 BACKGROUND INFORMATION

- 3.1 Over the past 12-18 months, MPF has been reviewing its responsible investment policy, its broader approach to Environmental, Social and Governance (ESG) factors and how to integrate good stewardship and engagement into the management of its assets, whilst maintaining its fiduciary responsibility to pay pensions.
- 3.2 Members will be aware that there has been a growing public campaign for MPF to divest from a range of companies in which it is invested which are deemed to be providing support for Israeli military activities in Gaza and other territories, in particular, and conflicts. Many but not all of these companies are categorised as in the 'Aerospace & Defence' sector. As of 25 November, 161 letters or emails had been received of which 119 were from local council taxpayers and 42 from members of MPF.
- 3.3 When making investment decisions, administering authorities must take proper advice and act prudently. In the context of the local government pension scheme, a prudent approach to investment can be described as a duty to discharge statutory responsibilities with care, skill, prudence and diligence. This approach is the standard that those responsible for making investment decisions must operate.
- 3.4 Although administering authorities are not subject to trust law, those responsible for making investment decisions must comply with general legal principles governing the administration of scheme investments. They must also act in accordance with ordinary public law principles, in particular, the ordinary public law of

reasonableness. They risk challenge if a decision they make is so unreasonable that no person acting reasonably could have made it.

- 3.5 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. "Support" is not defined in the case law but it could be interpreted as a reasonable belief that not less than 75 % of scheme members (properly informed of the relevant facts and their implications) would actively agree to the proposition. That belief would have to be supported by evidence if a moral consensus could not be reasonably presumed.
- 3.6 Engagement is an integral part of MPF's responsible asset ownership practices and is exercised principally through the Fund's external investment managers, membership of the Local Authority Pension Fund Forum (LAPFF) and membership of the Institutional Investor Group on Climate Change (IIGCC). Engagement is recognised as the most effective way of achieving change, but it is acknowledged that there will be instances where engagement is ineffective or not appropriate and an assessment may then be made as to the merits of retaining the investment or, if feasible, disposing of it. To this end, MPF has developed a framework approach to engagement which includes some broad principles around divestment. These are set out later in the report.
- 3.7 To test these principles, and by way of a case study, Redington prepared a paper considering what factors the Fund could take into account when thinking about its investments in defence companies. Whilst investments in defence companies have always had a level of controversy, this has been heightened over recent years by conflicts in Russia/Ukraine and Israel/Gaza. In general, investment funds labelled as 'ethical' exclude weapons, particularly those categorised as 'controversial'¹. However, a recent FT article² notes that "many investors have also bought into the argument from governments that backing arms makers, long the subject of boycotts and student protests, should carry positive social connotations rather than exclusively downside risk" and that "about a third of funds in Europe and the UK focused on environmental, social and governance issues now have €7.7bn invested in the sector, compared with €3.2bn in the first quarter of 2022."
1. Controversial weapons principally comprise those banned under international treaty.
 2. [Europe's ESG funds more than double defence holdings amid Ukraine war \(ft.com\)](#)
- 3.8 The Redington report identified a number of key considerations for Pensions Committee.
- What does the latest fiduciary guidance and draft legislation support?
 - What are the levers the Fund can use to support objectives?
 - What did the survey of responsible investment beliefs indicate?

3.9 There are a variety of ways in which engagement is undertaken by investors. The principal mechanisms in current use are set out below. All have been employed by MPF to a lesser or greater extent.

- Through fund managers
- Through specialist service providers
- In industry groupings

3.10 Four considerations for Members in relation to the way in which engagement might best be directed by MPF:

- Materiality: focus on issues that are financial material
- Scope for influence: focus on matters where MPF can have a substantive influence
- Sensitivity & interest: focus on issues of meaning or significance to MPF or its members
- Timing: significance of issue relative to other sector/investment specific matters at the time

3.11 Exercise of judgment in relation to exclusion

3.12 Redington has analysed the exclusion decisions of a number of leading European institutional investors. The analysis reveals a lack of consistency of approach even amongst peers and funds that use exclusion as one of their key levers and are considered by some to be particularly advanced in ethical investment thinking. There is a degree of commonality, but the analysis shows that a degree of subjectivity remains.

3.13 Defence companies are categorised in the 'Aerospace & Defence' sector. As the name of the sector suggests, for many companies, civil aviation is their predominate activity.

3.14 Many companies do not manufacture weapons but may produce components that are included in their production e.g. engines, fuselage, armour. 'Key components' may be difficult to define.

3.15 Some companies produce defensive products e.g. decoys, anti-drone, detection systems, cyber-security, body armour, respiratory protection etc.

3.16 There are businesses located in the local area which provide employment and pay council tax. Is it consistent for an LGPS fund to exclude a business that the local authority is willing to accommodate?

3.17 Many weapons today are so-called 'smart weapons' in view of the technology involved in their operation. With IT in some form intrinsic to many weapons, what are the implications for manufacturers of semiconductors, software, operating systems etc. Technology is also fundamental to communications, mapping and other surveillance.

3.18 Scope of policy – precedent setting

- 3.19 It is necessary that any policy that is agreed has a general application to investment controversies that may be raised with MPF. What other sectors/stocks would fall within the policy as many companies are involved in activities which can be deemed to cause harm of one kind or another.
- 3.20 **Recent Guidance and Legal Opinion**
- 3.21 The LGPS Scheme Advisory Board (SAB) recently issued some updated guidance for Administering Authorities as a reminder of Fiduciary Duty ([Guidance](#)) and lobbying pressure that some Pensions Committees have faced over the recent conflict between Israel / Gaza, noting “It is not appropriate for investment decisions to be driven directly by the political views of Pension Committee members or indeed Government ministers (except as where prescribed in law, e.g. under the Sanctions and Anti-Money Laundering Act 2018). The Supreme Court held, in its judgment on the Palestine Solidarity Campaign case, that it is not appropriate for political preferences, whether local or national, to take precedence over what is required under the fiduciary duty. This makes Pension Committees different from other local government committees that are dealing with service provision, and which have to make political choices about the prioritisation of scarce public resources. The Supreme Court (in the above case) was clear that administering LGPS funds is not best understood as a “local government function” or “part of the machinery of the state”, instead Pension Committees operate in a quasi-trustee role”
- 3.22 Further the LGPS SAB has sought to obtain Leading Counsel advice on the LGPS and implications of the current events concerning Gaza following a number of administering authorities receiving letters allege that they are acting unlawfully by holding, and failing to divest from, investments in companies which have been linked to the ongoing situation in the Middle East. Counsel advice was published on 24 October 2024 ([Legal Opinion](#)). The legal opinion has been sought following receipt by some administering authorities of letters, raising concerns about the investment of LGPS funds in what are said to be “companies in violation of international law”.
- 3.23 Nigel Giffin, KC considered the allegations being made reflecting on the current status of the law and concluded “This Opinion is concerned with the suggestion that it would be unlawful for administering authorities to invest, or continue to invest, LGPS funds in undertakings engaged in certain activities with a bearing upon Israel’s conduct in and in relation to Gaza or the other Palestinian territories. In my view, any such suggestion is incorrect”.
- 3.24 An important consideration is the regulation of export licences for weapons by the UK Government and recent action by the UK Government. The UK government has access to intelligence, information and sources that are not available to organisations such as MPF and is better placed to assess the situation in areas of conflict. The fact that the government has recently taken steps to suspend a number of export licences to Israel on humanitarian grounds goes some way to validating reliance on this process. It should be noted that whilst the government has introduced the suspension of some export licences to Israel on humanitarian grounds, this has been very limited in scope. Indeed, the press release on suspension of export licences the Foreign Secretary underlined support for Israeli security and confirmed “... this is not a blanket ban. This is not an arms embargo. It

targets around 30 of approximately 350 licences to Israel in total for items which could be used in the current conflict in Gaza. The rest will continue.”

- 3.25 If the recommendation in this report is supported, it is proposed that officers will provide further information, at a future RIWP, of any investments falling into this category. Officers recognise the importance of improving communication of responsible investment activities and are working on enhancing this area. The present consultation may also have implication for the implementation of responsible investment policies and Officers will provide further information on this once there is clarity on the outcome.

4.0 FINANCIAL IMPLICATIONS

- 4.1 As set out in the report.

5.0 LEGAL IMPLICATIONS

- 5.1 As set out in the report.

- 5.2 The administering authority’s solicitor, acting for the Fund, provides advice as to the implementation and interpretation of legislative and governance requirements.

- 5.3 LGPS administering authorities have a fiduciary duty to act in the best interests of scheme members. Investment powers must be directed to achieving what is the best for the financial position of the fund.

6.0 RESOURCE IMPLICATIONS: STAFFING, ICT AND ASSETS

- 6.1 None arising directly from this report.

7.0 RELEVANT RISKS

- 7.1 As set out in the report. There are potential investment-related, financial and reputational risks arising from the Fund’s investments and it is important that these are managed and mitigated by effective stewardship.

8.0 ENGAGEMENT/CONSULTATION

- 8.1 The Local Pension Board has been consulted in accordance with statutory guidance.

9.0 EQUALITY IMPLICATIONS

- 9.1 Ministry of Housing, Communities and Local Government (MHCLG) and the Pensions Regulator undertake equality impact assessments regarding the provisions of the LGPS Regulations and the administration and governance of public service pension schemes.

- 9.2 The Equality Statement published on the introduction of the Local Government Pension Scheme 2014 can be viewed at: <https://mpfund.uk/lgpsequalitystatement>

9.3 MHCLG and HM Treasury undertake equality impact assessments with regard to the statutory reform of the public sector pension schemes and LGPS.

10.0 ENVIRONMENT AND CLIMATE IMPLICATIONS

10.1 There are none arising directly from this report.

11.0 COMMUNITY WEALTH IMPLICATIONS

11.1 There are none directly arising from this report.

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APPENDIX

NONE.

BACKGROUND PAPERS

Local Government Pension Scheme: Investment Reform, Criteria & Guidance
<https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance>

TERMS OF REFERENCE

This report is being considered by the Pensions Committee in accordance with Section D of its Terms of Reference:

- (d) To monitor the Local Government Pension Scheme including the benefit regulations and payment of pensions and their day-to-day administration and to be responsible for any policy decisions relating to the administration of the scheme

Subject History (last 3 years)

Council Meeting	Date