

Pensions Committee

27 March 2019

Report title	Responsible Investment Activities	
Originating service	Pension Services	
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Recommendation for decision:

1. The Committee is recommended to approve the Fund's Framework and Strategy for Managing the risks and opportunities presented by climate change.

Recommendations for noting:

The Committee is asked to note:

1. The Fund's voting and the Local Authority Pension Fund Forum's (LAPFF's) engagement activity for the three months ending 31 December 2018, including Appendix A.
2. The issues discussed in the LGPS Central Quarterly Stewardship Report which is available on the LGPS Central website:
<https://www.lgpscentral.co.uk/responsibleinvestment/>
3. The issues discussed by LAPFF are set in the Quarterly Engagement Report which is available on the LAPFF website:
<http://www.lapfforum.org/publications/qrtly-engagement-reports/>
4. Correspondence received from the DivestWMPF campaign group, and the Fund's response, together with a request to LAPFF to consider direct engagement with Lockheed Martin.
5. Further work undertaken to develop the Fund's responsible investment approach.

1.0 Purpose

- 1.1 To update the Pensions Committee on the work undertaken in relation to responsible investment activities since the last Pensions Committee meeting.

2.0 Background

- 2.1 The Fund has a longstanding policy of supporting good corporate governance in the companies in which it invests. The Fund will also challenge companies who do not meet either the standards set by their peers or reasonable expectations as measured by best practice. The Fund's approach is part of its overall investment management arrangements and its active responsible investment framework. There are three main pillars to the framework: **selection** (of assets), **stewardship** (of assets), and **transparency & disclosure**.

3.0 Responsible Investment Activities

Engagement through Partnerships

- 3.1 The Fund's strategy is to engage with its investee companies and other key stakeholders through partnerships and on its own. The Fund aims to protect and increase shareholder value by engaging on a range of financially material ESG investment factors. A significant part of the Fund's engagement programme is implemented through partnerships including the Principles for Responsible Investment (PRI), the Local Authority Pension Fund Forum (LAPFF), Hermes EOS (via a contract held by LGPS Central, the Fund's asset pool), Institutional Investors Group on Climate Change (IIGCC) and the UK Pension Fund Roundtable.
- 3.2 Through LAPFF, the Fund engaged with 95 companies during the quarter. Most engagements concerned the use of plastics, and climate change. Five engagements led to a small improvement. Most engagements were conducted by writing letters to the company concerned. A summary of LAPFF's engagement activities for the quarter are provided alongside the voting activity report in Appendix A. The issues are set out in the Quarterly Engagement Report which is available on LAPFF's website:
<http://www.lapfforum.org/publications/qrtly-engagement-reports/>
- 3.3 Through Hermes EOS, the Fund engaged 232 portfolio companies during the quarter, covering 613 environmental, social and corporate governance issues. Hermes EOS' activities support delivery against the Fund's stewardship themes, which are currently climate change, cyber security and diversity. Further details of Hermes EOS' engagement activity is found in Appendix B.
- 3.4 The Fund's stewardship themes for 2018/19 are climate change, cyber security and diversity. These themes have been selected because they have both financial relevance and resonance with the Fund's stakeholders. The Fund is, primarily through partnerships, engaging with companies, fund managers and other relevant organisations, and using its voting rights to drive change and signal the importance of these issues to institutional investors. Progress on each theme is reported to the Pensions Committee on a quarterly basis.

Climate Change

- 3.5 The Fund has continued its proactive programme of climate change stewardship, primarily by leveraging its strategic partnerships including LAPFF, LGPS Central, Hermes EOS, the Transition Pathway Initiative, the Climate Action 100+ Initiative, and the Institutional Investor Group on Climate Change.
- 3.6 Acting on the Fund's behalf, LGPS Central was among the first investors to file a resolution at BP Plc that commits the company to make capital expenditure decisions in alignment with the goals of the Paris climate accord. The resolution was welcomed by the company's board and executive management, echoing the 'Aiming for A' resolutions that the Fund co-filed in previous years. It is a pragmatically articulated mandate for the company to transition its business model and remain viable in a carbon constrained world.
- 3.7 Also through LGPS Central, focussed engagement with Glencore Plc yielded a public statement from the company which commits the company to make strategic business decisions in line with the Paris agreement on climate change. The company had not previously recognised the Paris goals – i.e. holding the increase in the global average temperature to well below 2°C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels – meaning that the engagement outcome represents a marked improvement in the company's climate strategy. Significantly, the company has committed to limit coal production and to prioritise areas of the business that have a role in facilitating lower carbon technologies, for example copper, cobalt, nickel, vanadium and zinc.
- 3.8 The Transition Pathway Initiative (TPI) is one of the Fund's strategic partners for engaging companies on climate risk management. Headed by a steering group of asset owners, TPI is powered by climate change experts at the London School of Economics, and the data provider FTSERussell. Research on the climate change preparedness of the airlines sector was recently released by TPI, with twenty listed airlines companies assessed for management quality (i.e. governance of climate risks) and carbon performance (i.e. alignment with a 2°C scenario). In terms of management quality, one company is rated as Level 0 ('climate unaware'), while four companies make Level 4 ('strategic assessment of climate risks'). None make the highest assessment, Level 4*. Easyjet Plc is rated at Level 2 ('building capacity') and British Airways parent company International Consolidated Airlines Group SA is rated Level 3 ('integrating climate change into operational decision making'). The Fund has previously voted against the re-election of company Chairs where the TPI management quality rating was excessively poor.
- 3.9 In December, global policy-makers met in Katowice at COP 24 – three years since the Paris accord was signed at COP 21. The outcomes were better than expected, with an agreed 'rulebook' to operationalise the goals of the Paris Agreement when it enters into force in 2020. As previously communicated to the Committee, the Fund signed up to Investor Agenda, a global statement calling on policy makers to achieve the Paris Agreement's goals, accelerate private sector investment into the low carbon transition, and commit to improve climate-related financial reporting. The IIGCC (Institutional

Investor Group on Climate Change) lobbied on its members' behalves – including the Fund –for a strong outcome to the talks. The downsides to COP24 was the failure to unreservedly acknowledge the significance of the Intergovernmental Panel on Climate Change (IPCC) “Special Report on 1.5 Degrees” and to delay by 12 months an agreement on the global trading of carbon credits. We will continue to support a policy environment sufficient to achieve the goals of the Paris climate accord.

Cyber Security

- 3.10 During the period in review, malicious cyber activity continued to hit the headlines with the “London Blue” hackers targeting 35,000 chief financial officers requesting money transfers through a business email compromise strategy. In October, Tesco Bank received a £16.4m fine from the FCA following a 2016 cyber-attack that led to the theft of £2.26m from current accounts. Tesco Bank’s experience is part of a broader trend in financial services where the number of breaches reported to the FCA increased from 25 in 2017 to 145 in 2018. In addition, the previously held assumption that cyber risk can be fully transferred through insurance contracts is being tested. Zurich Insurance Group is reportedly in dispute with Mondelez over a claim relating to \$100m of damages incurred during the NotPetya attack.
- 3.11 On the Fund’s behalf, LGPS Central has continued to participate in a PRI-led group engagement on cyber security and data protection. Of 65 companies that have been approached in the engagement, 59 have responded, and 42 meetings have taken place. During the quarter we progressed engagement milestones with a UK telecoms company, a European financial services company, a US IT company, a UK bank and a US healthcare company. The group has found a number of respondents to be reluctant to divulge information to shareholders and particularly in the public domain. US companies in particular were reluctant to grant the group access to board members to discuss cyber security. We would like the target companies to assure investors that the board has accountability for cyber risks, a clear line of sight as to the systems for managing this risk, and that there is due regard for cyber expertise and experience within the directors put forward for (re-)election to the board.

Diversity

- 3.12 At a recent meeting with the Chair of Tullow Oil Plc, the company committed to having 30% of its Board comprised of female directors by 2020. We were very pleased to see Tullow back up this commitment with the appointment in February 2019 of two female board directors, bringing the proportion of female directors on the board to 33% of total. Writing to the company following this announcement, LGPS Central praised on behalf of the 30% Club Investor Group – of which the Fund is an active member – the leadership shown by Chair Dorothy Thompson.
- 3.13 On the Fund’s behalf, LGPS Central responded to a consultation concerning ethnicity pay gap reporting, welcoming the proposal to introduce such disclosures. For large, diversified investors, the value of easily attainable and commonly reported data cannot be overstated. This is for several reasons including (a) investors can observe with

greater ease which parts of their portfolio are deserving of greatest attention, and (b) data can set the framework for meaningful discussions with company management and boards. In the consultation response LGPS Central encouraged BEIS¹ to mirror the requirements for gender pay gap reporting, a swift implementation deadline, global data coverage, and ongoing measurement of the effectiveness of diversity pay reporting requirements, for example by surveying business leaders, HR specialists, board members, investors, and the workforce to see how the data is being used and whether meaningful change has occurred. The consultation response is published in full on the LGPS Central website.

- 3.14 In recent weeks and through the 30% club, the Fund has supported engagement with a medium sized FTSE 350 company on board governance, including independence and process for nominations and succession planning, in view of recent CEO and Board turnover.

Voting Globally

- 3.15 The Fund's voting policies are currently executed by Hermes EOS via a contract held by LGPS Central, the Fund's asset pool. The Fund has contributed to and endorses LGPS Central's Voting Principles.
- 3.16 The voting activity for the quarter across markets and issues can be found in Appendix A. During the period, the Fund voted at a total of 226 company meetings – 51 UK, 29 European, 18 North American, 22 Developed Asia, 79 Australasian and 27 in Emerging and Frontier Markets. During this period there were 120 meetings where the Fund supported all the resolutions put forward by companies. Approximately 15% of the resolutions were not supported by the Fund. The largest number of resolutions that were opposed concerned the re-election of directors (usually voting against non-independent non-executive directors where the Fund or its advisors do not see sufficient independent oversight on a company board) and remuneration.

Framework and Strategy for Managing the risks and opportunities presented by climate change

- 3.17 The Committee will recall that at its meeting on 12 December 2018, a set of beliefs about climate change, and its relevance for the Fund, were discussed, noted and endorsed. These have been taken as the basis for developing a framework that sets out the Fund's approach to managing the risks and opportunities presented by climate change. The Committee is presented in Appendix C with the proposed *Framework and strategy for managing the risks and opportunities presented by climate change*, which describes the Fund's proposed plan to address climate change over the coming four-year period (2019-2023).
- 3.18 Building from the beliefs approved by the Committee, the framework and strategy have been drafted based on five principles:

¹ Department for Business, Energy & Industrial Strategy, the issuers of the consultation

- **Integration:** connecting to and supporting the Fund's Investment Strategy Statement and Risk Register
 - **Informed:** that the best available evidence is used to inform the framework and strategy, which support the Fund's fiduciary duty to pay pensions
 - **High Ambition:** the Fund recognises its status as a large UK asset owner and seeks to establish a leadership position in matters of climate change management
 - **Actionable:** the framework and strategy are drafted in terms that describe clear actions such that progress can be observed and reviewed
 - **Holistic:** recognition that the scope of the pension fund's climate risk is broader than just its investment function, and far broader than just its investment in fossil fuel producers.
- 3.19 In addition, the framework and strategy are built on guidance from the Fund's climate change partners including the IIGCC's *Addressing climate risks and opportunities in the investment process* and the TCFD's *Final Report: Recommendations of the Taskforce on Climate-related Financial Disclosures*.
- 3.20 By way of delivering on the framework and strategy, the Fund will utilise a series of selected partners who we believe provide the best available resourcing for our "Strategic Actions". Consistent with the Fund's belief that collaboration is vital for the mitigation of climate-related risks, we will collaborate with our partner funds and with LGPS Central Limited in the delivery against the framework and strategy.
- 3.21 The Fund has received correspondence from scheme members and from non-scheme member stakeholders regarding climate change as a financial issue, and as an ethical issue. The Fund is fully aware of the regulations and statutory guidance relating to matters of responsible investment, and Committee members receive regular training on this subject. The draft framework has been shared with employers who have engaged with the Fund on this issue.

Other stewardship activities

- 3.22 On 25 January 2019, a tailings dam owned by Vale SA collapsed near Brumadinho in Brazil. At least 300 people are believed to have died in this incident. The day following the event, contact was made with a non-executive director at Vale SA to understand the Board's response to the tragedy. In the days following the tragedy, the Fund's asset pool collaborated with other global investors including the Church of England Pensions Board and the Swedish Council of Ethics to call for a step change in tailings dam management across the mining sector. A roundtable of investors, academics, and the mining industry was held at Church House in Westminster in February 2019. At this event, LGPS Central joined other investors in calling for an independently managed, and publicly disclosed, classification system for all tailings dams, based on the consequences of dam failure. The Fund, along with LGPS Central, will continue to monitor the situation.

Correspondence

- 3.23 During December 2018, some members of the Pension Committee were sent a report by the local campaign group DivestWMPF – “The Fossil fuel Five – Can the West Midlands Pension Fund trust the majors to stop climate breakdown?”. The group is known to the Fund and has been campaigning for the Fund to divest from Fossil Fuels since at least 2016.
- 3.24 Following receipt of the DivestWMPF report, Fund officers briefed the Pensions Committee on the Fund’s existing approach to managing climate risk. The Fund also responded directly to the campaign group, noting the climate-related investment beliefs approved by the Committee in December 2018. The Fund believes that it has an appropriate framework and strategy to manage the financial risks associated with climate change.
- 3.25 At the Committee meeting in December, Councillor Mutton noted correspondence he had received in relation to the Fund’s investment in a Coventry-based company, Lockheed Martin and its involvement in the arms trade in Yemen. The Fund has reached out to LAPFF to consider direct engagement with the Company to better understand its approach and relationship with Leidos. The Committee will be updated as this dialogue progresses.

4.0 Financial implications

- 4.1 The promotion of good corporate governance amongst companies in which the Fund invests is complementary to the Fund’s objective of maximising financial returns, as it is widely believed that good corporate governance improves shareholder value in the long term.

5.0 Legal implications

- 5.1 This report contains no direct legal implications.

6.0 Equalities implications

- 6.1 This report contains no equal opportunities implications.

7.0 Environmental implications

- 7.1 Environmental implications are addressed through the Fund’s Responsible Investment Framework.

8.0 Human resources implications

- 8.1 This report contains no direct human resources implications.

9.0 Corporate landlord implications

9.1 This report contains no direct corporate landlord implications.

10.0 Schedule of background papers

10.1 LGPS Central Quarterly Stewardship Report:
<https://www.lgpscentral.co.uk/responsibleinvestment/>

10.2 LAPFF Quarterly Engagement Report:
<http://www.lapfforum.org/publications/qrtly-engagement-reports/>

11.0 Schedule of Appendices

11.1 Appendix A (WMPF Voting and Engagement Activity)

11.2 Appendix B (Hermes EOS Engagement Report, Q4 2018)

11.3 Appendix C (*Framework and Strategy for Managing the risks and opportunities presented by climate change*)