



City of Westminster

# Committee Report

<b>Decision Maker:</b>	<b>PENSION FUND COMMITTEE</b>
<b>Date:</b>	<b>15 November 2016</b>
<b>Classification:</b>	<b>Public</b>
<b>Title:</b>	<b>Investment Regulations and Investment Strategy Statement</b>
<b>Wards Affected:</b>	<b>All</b>
<b>Policy Context:</b>	<b>Effective control over Council Activities</b>
<b>Financial Summary:</b>	<b>There are no financial implications arising from this report.</b>
<b>Report of:</b>	<b>Steven Mair</b> <i>City Treasurer</i> <a href="mailto:smair@westminster.gov.uk">smair@westminster.gov.uk</a> <b>020 7641 2904</b>

## 1. EXECUTIVE SUMMARY

- 1.1 The Government has issued guidance on the preparation of Investment Strategy Statements (ISS) as required under the soon to be released revised investment regulations. This note summarises the anticipated investment regulations and the finalised guidance.
- 1.2 The investment environment under the new regulations will be one of increased freedom but with more onerous justification of investment policy together with greater requirements to consult with interested parties and to report on the application of policy. There will also be greater Government powers of intervention, mainly but not exclusively, aimed at pooling.
- 1.3 It is not anticipated that the Committee will have to alter its current investment strategy. It may well have to consider the extent of diversification and the adequacy of risk management, which was already anticipated post the actuarial review.
- 1.4 The Committee will be required to review its policy on ethical, social and corporate governance issues and in particular to discuss oversight of voting with the London Collective Investment Vehicle (CIV).

## **2. RECOMMENDATIONS**

### **2.1 The Committee is invited:**

- a. To note that a draft Investment Strategy Statement (ISS) prepared in accordance with the revised investment regulations and guidance will be presented to the March 2017 Committee meeting.
- b. To discuss the requirement for greater detail on environmental, social and corporate governance (voting) matters including greater consultation with interested parties, including the Pension Board, which will have to be reflected in the ISS.

## **3. PROPOSALS AND ISSUES**

- 3.1 The Government issued revised investment regulations in September 2016, to have effect from 1<sup>st</sup> November 2016. The centre piece of the regulations was the replacement of the Statement of Investment Principles (SIP) with a requirement to prepare and operate in accordance with an ISS. Guidance has recently been issued on the preparation of an ISS. Each scheme is required to have an ISS by 1<sup>st</sup> April 2017 and a draft will be presented to the 21<sup>st</sup> March 2017 meeting of the Committee.

### **Overview of the Investment Regulations**

- 3.2 The revised investment regulations are quite short, running to only seven pages. The key deletion is the old schedule 1 that specified limits on the allocation to particular types of assets. The main sections in the investment Regulation are:
- a) Requirement to keep the assets of the pension fund separate from those of the administering authority, to collect contributions and income and to operate separate bank accounts for the fund.
  - b) No borrowing is permitted except temporary loans (90 days max) to allow the payment of pensions.
  - c) An authority must, after taking proper advice, formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State. The ISS must include:
    - a requirement to invest fund money in a wide variety of investments;
    - the authority's assessment of the suitability of particular investments and types of investments;
    - the authority's approach to risk, including the ways in which risks are to be measured and managed;

- the authority's approach to pooling investments, including the use of collective investment vehicles and shared services;
- the authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments;
- the authority's policy on the exercise of the rights (including voting rights) attaching to investments;
- the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment (a scheme specific replacement of the old schedule 1);
- The authority must consult such persons as it considers appropriate as to the contents of its investment strategy; and
- The ISS must be reviewed at least every three years and investments must be made in accordance with the ISS.

These requirements are discussed below (paragraph 3.8). The requirements to take 'proper advice' and to invest in a wide variety of investments may potentially lead to challenge and debate with the investment advisor.

d) The Government can give directions to the administering authority if it is satisfied that the authority is not having regard to the ISS guidance. Directions may include:

- A requirement to make changes to the ISS;
- How to invest particular assets; and
- Transfer of the investment functions to the Government or nominated person.

The guidance (paragraph 3.6 below) discussed the circumstances when the powers of direction will be used. The regulations require the Government to consult with the administering authority in advance of any direction and to consider evidence as to how the fund is being managed.

e) The authority must take proper advice before making investment manager appointments. This presumably includes transferring assets to the London CIV.

3.3 The ISS requires additional details compared with the SIP (in particular on risk management, pooling, ESG and voting), which are discussed below. As mentioned above, a draft ISS reflecting the current position of the fund will be prepared for the 21 March 2017 meeting.

3.4 The application of the Government's powers of direction is also discussed in the guidance. Such are the scope of the powers that it is

anticipated that authorities who could not address the Government's concerns during the consultation period will take the required action in advance of a direction being issued.

## **ISS Guidance**

- 3.5 The guidance is designed to assist in preparing the ISS. As highlighted above the ISS must be in accordance with the guidance. The guidance is summarised below.

### Powers of Direction

- 3.6 The guidance refers to the new freedoms for administering authorities (no schedule 1 limitations) and the ISS being a 'prudential framework' and the powers of direction as a safeguard to ensure that this less prescriptive approach is used appropriately and in the best long term interests of scheme beneficiaries and taxpayers. The guidance refers to prior consultation and the general law principle to make investment decisions in the best long term interest of beneficiaries and tax payers.
- 3.7 The consultation previously indicated that powers of intervention were mainly aimed at authorities that did not participate in pooling. The guidance does not state this, but it presumably remains the main purpose. The Committee will need to consider the meaning of best long term interest, which presumably relates to solvency, cost and taking decisions based on long term returns. One view point is that a thoughtful Committee should not be concerned with the use of the powers. An alternative viewpoint is that future Governments may take a different (and issue specific) view of best long term interest. There is no way to prejudge how these powers will be applied by the current and future Governments. In preparing the ISS, the Committee will need to be diligent in addressing each of the bullet points in 3.2(c).

### Contents of ISS

- 3.8 The guidance summarises the requirements when preparing an ISS as follows:
- Must take proper advice;
  - Must set out clearly the balance between different types of investments;
  - Must identify the risks associated with their overall investment strategy;
  - Must periodically review their policy to mitigate against any such risks;
  - Should ensure that their policy on asset allocation is compatible with achieving their locally determined solvency target;
  - Must periodically review the suitability of their investment portfolio to ensure that returns, risk and volatility are all appropriately managed and are consistent with their overall investment strategy;

- Should clearly state their appetite for risk;
- Should be aware of the risks that may impact on their overall funding and investment strategies;
- Should take measures to counter those risks;
- Should periodically review the assumptions on which their investment strategy is based; and
- Should formulate contingency plans to limit the impact of risks that might materialise.

3.9 None of the above should cause any concern to the Committee. If not already explicitly stated in the SIP or elsewhere (e.g. funding strategy statement) it will be implicit in the current strategy and the actions taken by the Committee. Addressing these questions is good practice.

#### Pooling

3.10 The regulations require that each Fund must commit to a [singular] pool that meets the pooling criteria issued last year, or otherwise approved. Particular requirements within the guidance are:

- To notify the Scheme Advisory Board and the Secretary of State of any changes [in pool governance structures] which result in failure to meet the criteria;
- Set out the proportion of assets that will be invested through pooling;
- Set out the structure and governance arrangements of the pool and the mechanisms by which the authority can hold the pool to account;
- Set out the services that will be shared or jointly procured;
- Provide a summary of assets that the authority has determined are not suitable for investing through the pool along with its rationale for doing so, and how this demonstrates value for money;
- Regularly review any assets, and no less than every 3 years, that the authority has previously determined should be held outside of the pool, ensuring this continues to demonstrate value for money; and
- Submit an annual report on the progress of asset transfers to the Scheme Advisory Board.

3.11 In complying with aspects of these regulations e.g. pool governance arrangements, it is expected that the London CIV will prepare standardised content. The references to assets to be pooled or excluded should cause no concern if the Committee remains comfortable with the London CIV as the platform for fund manager appointments. The reference to pooling decisions being based on 'value for money' considerations may or may not imply that it is purely the cost of managing assets that should be considered and not potential returns. Unless the Committee has issues with pooling, the exact definition of 'value for money' has no practical implications.

### Social, Environmental or Corporate Governance Considerations

- 3.12 The first part of the guidance seeks to prevent 'boycotts, disinvestment and sanctions against foreign nations and the UK defence industries' other than Government sanctions by stating the legal basis on which investment decisions must be made. These include:
- Taking proper advice and act prudently;
  - Prudently being defined as a duty to discharge statutory responsibilities with care, skill, prudence and diligence;
  - To act in accordance with ordinary public law principles, in particular, the ordinary public law of reasonableness;
  - Schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors over the long term.
- 3.13 None of the above appears to be different from the basis on which the Committee currently operates and thus have no immediate consequences.
- 3.14 The guidance continues "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." The use of non-financial considerations has to be quantified and explained in the ISS.
- 3.15 The above wording although consistent with the Committee's current approach is likely to be seen as an invitation to scheme members to express views on social and environmental aspects of investment policy. This is amplified in a discussion on social investments (where the social impact may be in addition or part substitution to the financial return) where it is stated that "these investments will also be compatible with the prudent approach providing administering authorities have good reason to think scheme members share the concern for social impact, and there is no risk of significant financial detriment to the fund." When presented with 'social investments' the Committee will have to consider whether any adverse financial consequences are 'significant' and balances by social benefits.
- 3.16 The guidance requires that when setting policy on social, environmental and corporate governance matters, the Committee 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. Although the Committee is at liberty to not have a process for seeking views of interested parties, they should be wary of challenge and the Government's powers to amend the ISS. It is

suggested that the policy of these issues is reconsidered from the standpoint of seeking to consult with the Pensions Board.

#### The Exercise of Voting Rights

- 3.17 The final section of the guidance is concerned with ensuring the highest standards of corporate governance in the companies in which funds invest. Good governance is seen as enhancing shareholder value. Stewardship activities include monitoring and engaging with companies with the aim of exerting a positive influence on companies to promote strong governance, manage risk, increase accountability and drive improvements in the management of environmental, social and corporate governance issues.
- 3.18 The Committee's current policy is that corporate governance activity, including voting, is an essential part of the decision to buy and hold investments and should be undertaken by the appointed investment managers. The guidance 'encourages' (not the same as requires?) Funds' to consider the best way to engage with companies either directly, in partnership with other investors or through their investment managers, and explain their policy on stewardship with reference to the Stewardship Code. The new requirement is that administering authorities should become Signatories to the Stewardship Code and state how they implement the seven principles and guidance of the Code, which apply on a "comply or explain" basis. A summary of the Stewardship Code is attached (Appendix 1).
- 3.19 The guidance requires a discussion within the ISS on the exercise of voting rights, including holding investment managers to account on voting records and stewardship in general. There is a suggestion on appointing an independent proxy voting agent to exercise their proxy voting and monitor the voting activity of the managers. Finally, a requirement to publish a report of voting activity as part of the pension fund annual report.
- 3.20 The current social, environmental and ethical policy as set out in the SIP is:
- "The Fund recognises that the neglect of corporate governance and corporate social responsibility may lead to poor or reduced shareholder returns. The Committee has considered how the Fund may best implement a corporate social responsibility policy, given the current resources available to the Fund. Accordingly, the Committee has delegated social, environmental and ethical policy to the investment managers. The Committee believes this is the most efficient approach whilst ensuring the implementation of policy by each manager is consistent with current best practice and there is appropriate disclosure and reporting of actions taken. To that extent, the Committee maintains a policy of non-interference with the day-to-day decision making of the investment managers."

- 3.21 The Committee went to considerable effort to establish a Stewardship Policy setting out the basis on which fund managers were expected to vote. In particular the policy identified common stewardship concerns (e.g. executive remuneration) and informed fund managers the issues that they should consider when voting. The policy was approved by the Committee in November 2014 and was subsequently circulated to fund managers. It includes a promise to publish annually a statement on these stewardship activities undertaken by the Committee. If the Committee follows through on the policy and signs up to the UK Stewardship Code itself, then it would be fully compliant with the guidance.
- 3.22 It is likely that the Committee's current approach of delegation to fund managers remains valid but will have to be explained. Also that the fund managers will be required to report on voting activity, in particular failures to vote. The requirement to comment on voting in the annual report is not onerous. However, it can be expected that there will be greater interest in voting.
- 3.23 All this is either made more complicated or potentially simplified by the London CIV. With the CIV appointing fund managers they will be expected to exercise the oversight discussed above. It will not be possible within pooled funds for the Committee to operate its own voting policy. Rather pressure will be brought on the London CIV if their policy is deemed inadequate.

#### **4 IMPLICATIONS FOR THE PENSION FUND COMMITTEE**

- 4.1 Looking from a high level the new investment regulations and guidance do provide greater freedom to set strategy. However, the regulations and guidance' requires that strategy be justified based as in the best long term interest of beneficiaries and tax payers and the management of risk explained. This should be seen as best practice, although with an unwelcome degree of Government oversight.
- 4.2 The requirements for ethical, social and corporate governance will require a review of the Committee's current approach to these issues, in particular a discussion with the London CIV in connection with the Stewardship Code, increased reporting and greater effort to take into account the views of the Pension Board and Scheme Members. These areas will be addressed in drafting the ISS in the next few months.
- 4.3 Overall, the regulations and guidance offer the opportunity to review current investment policy and ensure that justification is adequately documented.



**If you have any questions about this report, or wish to inspect one of the background papers, please contact the report author:**

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**BACKGROUND PAPERS:**       None

**APPENDICES:**

Appendix 1 – Summary of UK Stewardship Code

## **UK Stewardship Code Summary**

The Financial Reporting Council (FRC) published the UK Stewardship Code (the Code) in July 2010. The Code is designed to lay out the responsibilities of institutional investors as shareholders and provide guidance as to how those responsibilities might be met. Pension fund trustees and other investors are 'strongly encouraged' to 'report if and how they have complied with the Code'

The Stewardship Code consists of seven key Principles:

Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.

Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed.

Principle 3: Institutional investors should monitor their investee companies.

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate.

Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity.

Principle 7: Institutional investors should report periodically on their stewardship and voting activities.