| Non-Executive Report of the:<br>**PENSIONS COMMITTEE**<br>**16 March 2017** |  |
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| **Report of:** Zena Cooke, Corporate Director of Resources | **Classification:** |
| **Update on Environmental, Social & Governance (ESG), Fossil Fuels and Low Carbon Approach for Tower hamlets Pension Fund** | |

| **Originating Officer(s)** | Bola Tobun, Investment and Treasury Manager |
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| **Wards affected** | All |

The purpose of this report is to give update on meetings held December 8th 2016 and 14th February 2017. The meetings were to introduce, update and for the Committee to discuss issues and approaches to mitigate risks posted by climate change, fossil fuels in order to formulate a cost effective Fund's Ethical, Social and Governance (ESG) Policy.

A set of recommendations were provided to the committee for consideration and approval at the meeting of 8 December 2016.

The Pensions Committee is recommended to note this report and to consider and to approve recommendations set below:

a. *Commit to the UK Stewardship Code.*
b. *Develop a policy statement regarding the London Borough of Tower Hamlets' approach to fossil fuel investment with a view to inclusion as a section within the new Investment Strategy Statement (ISS), which is the new name for the current Statement of Investment Principles.*
c. *Review options for switching some of the UK passive mandate into a low carbon target index fund.*
d. *Consider options for an initial* ***active investment*** *of approximately 5% of the Fund in a sustainability/low carbon or clean energy fund(s). Given the right risk/return profile, investment in such a fund would demonstrate the Fund's commitment to invest in clean and sustainable companies.*
e. *Monitor carbon risk within the London Borough of Tower Hamlets Pension Fund and to appoint a specialist contractor to conduct a carbon footprint review of the Fund at an estimated cost of between of £5k to £20k.*
f. *Continue engagement activities with the Fund's investment managers on their approach to fossil fuel and to promote consideration of climate change issues with managers when making investment decisions.*
g. *Maintain an active approach to climate change issues with investee companies and look for further opportunities to work with others on issues of ESG importance.*

## 1. REASONS FOR THE DECISIONS

1.1 The Pensions Committee act in the role of quasi trustees for the Pension Fund and are therefore responsible for the management of £1.31 billion worth of assets and for ensuring the effective and efficient running of the Pension Fund. The

management of the Fund's investment portfolio and the investment returns that the Fund is able to deliver have significant financial implications, not just for the Fund itself but also on the Fund's employers in terms of the level of contributions they are required to make to meet the Fund's pension undertakings, which are underwritten by statute.

1.2 The Fund recognises that investment in fossil fuels and the associated exposure to potential 'stranded assets' scenarios may pose material financial risks. These risks apply not only to the Fund's investment portfolio but also, when considered on a wider scale, to long term global economic growth.

1.3 In recognising the risks that climate change and stranded assets scenarios could pose to the Fund, the Committee needs to understand where these risks might apply and how they can best be mitigated within the investment management framework within which LGPS funds operate. The recommendations provided on this report are aimed at developing both a greater understanding of the risks and a set of strategies to help mitigate them.

1.4 The costs involved will very much depend on future decisions made around investment strategy. Climate change risk will be integrated into the forthcoming new Investment Strategy Statement to ensure that it is considered as part of the Committee's asset allocation decisions, rather than in isolation. Potential costs that could be incurred through development of the recommendations above include additional fees for use of low carbon indices; however, any such costs would need to be considered against the potential for risk mitigation and the performance of the mandate as a whole.

## 2. ALTERNATIVE OPTIONS

2.1 No alternative.

## 3. DETAILS OF REPORT

3.1 At the December meeting the Committee had an opportunity to discuss issue surrounding the call for disinvestment from fossil fuels (FF). This was done after presentations were received from a representative from Divest Tower Hamlets, Paul Spedding from Carbon Tracker, Clifford Sims a Partner from Squire, Patton, Boggs (LLP) and Ian Williams Group Director, Finance & Corporate Resources for LB Hackney with his Cabinet Member for Finance Cllr Geoff Taylor.

3.2 Divest Tower Hamlets

1) Divest Tower Hamlets told the Committee that they believe that the Tower Hamlets Pension Fund's investments in FF companies are not in the best financial interests of all its stakeholders, "the primary investment objective of the Pension Fund".

2) The Committee were advised that the Pension Fund should divest the approximately £91 million it reportedly has invested in FF companies.

3) The Committee were told about major divestments from funds like Rockefeller Brothers Fund, Norges Bank and the University of Oxford.

4) Divest Tower Hamlets told the Committee why engagement has not worked;

   a) FF companies have not responded to engagement efforts in the past

   b) FF companies' actions indicate they are likely to continue to ignore engagement.

5) The Committee were also presented with the environmental and financial factors for divesting.

3.3 Divest Tower Hamlets recommendations for the Pensions Committee were are as follows:

i. Divesting its holdings in the World's top 200 oil, coal and gas companies in full, or at least to the level adopted by the Environment Agency in 2015, that is to a level consistent with keeping below 2 degrees of global warming.

ii. A time frame for doing so (e.g. over the next 5 years)

iii. Refraining from making any new investments in FF companies

iv. Reinvesting a proportion of the divested funds in low carbon solutions.

3.4 Paul Spedding, Carbon Tracker Initiative, gave a presentation on the valuation implications of climate change. The presentation covered the following areas:

1) What does 450 scenario mean for the FF industry i.e. flat to reduced demand for oil, coal and gas

2) Investment in energy supply is still required under 2 degrees cap scenario

3) Valuation issues – volume, price and risk issues

4) Big oil model already broken – annual returns of oil shares and the return on capital even before the sharp fall in oil prices

3.5 Mr Spedding stated that until 2010 oil had been seen as a sound investment but since then the demand for FF had declined with coal down by 50%, oil by 25% and gas by 10%. Coal had been considered a significant part of the carbon risk and many factors had contributed to the drop in oil prices.

3.6 Mr Spedding indicated that the four relevant questions to ask a company in order to lower climate risk and these were:

1) Where are future developments;

2) Planning assumptions;

3) How sensitive is the business to oil price change; and

4) What is the target risk

3.7 Mr Spedding stated that Members should consider the financial impact and risks involved to the Pension Fund of any decision to disinvest and also whether the oil industry can deliver on target.

3.8 Mr Spedding also indicated that passive investments were growing due to the low fees and stewardship. In addition, carbon passive investment vehicles also reduced carbon footprint and incentivised Fund Managers to engage with investors to reduce climate change risks. And as times go by It is possible for many industries to substitute fossil fuel with more efficient and clean energy.

3.9 Mr Spedding indicated that if the oil and gas industry did not change its approach, the higher risk could lead to price pressure. Engagement by NGOs, Fund Managers and Pensions Funds collectively gave an opportunity for companies to change their strategy in relation to FF.

3.10 Clifford Sims, Squire Patton Boggs, gave a presentation on fiduciary duty of the committee in general in regards to investment decision making and specifically on fossil fuel divestment or investment decision making. He highlighted a section from LGPS (Management and Investment of Funds) 2009 regulations and DCLG consultation paper: 2016 Regulation.

3.11 Committee members were therefore reminded of their fiduciary responsibility and their primary duties including to consider the purpose of the pensions, investing money and act in accordance with the Investment Regulations 2009. Under the proposed 2016 Regulations, members could also take into consideration the non–climate factors.

3.12 Mr Sims said that when setting investment strategy, members should exercise discretion within the parameters of the regulation and any decision to disinvest must take into consideration any financial detriment to the scheme. Mr Sims referred to previous case law relating to breaches of fiduciary responsibility. Mr Sims stated that there was no statutory requirement to consult scheme members but the Committee could consult those appropriate; however there was an expectation to consult and inform the Pensions Board, as Board members had an oversight role and must report any failings it discovered to the regulator.

3.13 Mr Sims added for the Committee to discharge their fiduciary duty trustees must not act contrary to the benefit of scheme members.

3.14 The sentiment expressed by the Committee Members at the meeting is that active engagement will have more effect on corporate behaviour than disposing of investments. Recognising the pressure to be seen to be considering alternatives, there was also a request that additional information be provided on investing via low carbon or no carbon indices, hence the recommendations were approved.

3.15 The Committee decide to have a strategy meeting to further explore item 1.2 and 1.3 of this report on ESG and Fossil Fuels:

The items are as stated below:

a) *1.2 The Fund recognises that investment in fossil fuels and the associated exposure to potential 'stranded assets' scenarios may pose material financial risks. These risks apply not only to the Fund's investment portfolio but also, when considered on a wider scale, to long term global economic growth.*

b) *1.3 In recognising the risks that climate change and stranded assets scenarios could pose to the Fund, the Committee needs to understand where these risks might apply and how they can best be mitigated within the investment management framework within which LGPS funds operate. The recommendations provided on this report are aimed at developing both a greater understanding of the risks and a set of strategies to help mitigate them.*

3.16 In order for the committee to have better understanding and comfort of the above highlighted points, the following organisations presented to the committee at the 14 February 2017 strategy meeting:

- RBC - Nuts & Bolts of Sustainable Equity
- LGIM - Low Carbon Global Equities and FTSE All World ex CW Climate Balance Factor Index

***Further Information and Clarification on Items 1.2 & 1.3***

3.17 The Committee will need to consider carefully their duties to beneficiaries and employers before pursuing exclusionary. The proposal to utilise low carbon indices is supported by Funds and investment consultants on the grounds that the expected returns should be consistent long term with the main index.

3.18 The outcome of the international discussions, held in Paris from 30 November to 12 December 2015, involving negotiators from nearly 200 countries that resulted in an international accord to limit greenhouse gas emission clearly indicates that limiting exposure to companies involved in emitting high levels of carbon based emissions is potentially sensible from an investment viewpoint.

3.19 The idea that in future significant levels of fossil fuel reserves may in effect be "stranded" in the ground has become clearly more likely as a result of the 2015 Paris accord. A stranded asset is any asset that has, or has the potential to lose significant permanent economic value well ahead of its anticipated useful life as a result of changes in: legislation, regulation, market forces, disruptive innovation, changes in societal norms and social behaviour, environmental shocks, class actions and litigation, access to insurance and capital.

3.20 The outcome of the 2015 Paris climate management discussions support the view that the Fund amend its approach to Listed Equity investment to include an approach where a third of the Fund's Listed Equities are managed utilising the MSCI Low Carbon Target Index and or FTSE All World ex CW Climate Balance Factor Index.

3.21 L&G currently manage some £200 million from the Environment Agency Pension Fund against the MSCI Low Carbon Target index. The EAPF is at the forefront on sustainable investing and its use of this index provides a degree of re-assurance.

3.22 At the London Collective Investment Vehicles (LCIV) Stewardship seminar in February 2017, FTSE Russell presentation was on FTSE All World ex CW Climate Balance Factor Index, this product is currently being use by HSBC Pension Fund and being managed by LGIM. The presentation generated interests from about six London Funds and a sub working group has been formed by LCIV to explore and modify HSBC strategy into a better fit product for LGPS Funds.

3.23 Listed below are some key facts about FTSE All World ex CW Climate Balance Factor Index:

a) The FTSE All World ex CW Climate Balance Factor Index is a risk aware index.

b) The index methodology is designed to reflect the performance of the global diversified basket of securities.

c) A feature of the index is to target stocks high in factor exposures, but also incorporates climate change considerations.

d) FTSE Russell's LCE (Low Carbon Economy data model), is the database of the future, which the only database which looks at companies we would want to hold in years to come.

e) This index is rules-based constructed, and available via LGIM as the implementer. Quoted by LGIM as being an index of the future which will incorporate the many themes needed.

f) Asset Owners want an index solution that is consistent with its investment objectives.

g) This index looks at how companies operates and has excluded controversial weapons

h) This index looks at how carbon exposure and excludes companies with high fossil fuel reserves.

i) This index will then tilt companies with low operational carbon emissions.

j) The key part of this index is the LCE part, which looks at companies with green revenues and tilts / overweight's these companies. This way you are investing in companies who share price should in time increase.

k) The final part of the index is the factor tilt, which could incorporate value, low volatility, quality and size.

3.24 In conclusion reducing but not eliminating the Fund's exposure to investments in fossil fuels means that the Fund can still seek, from an "owners perspective" to

engage in engagement activities to persuade those companies involved in producing significant carbon emissions to consider whether, from a long term investment perspective, they might move away from their current activities towards less potentially environmentally damaging activities.

3.25 The Council has a fiduciary responsibility to obtain the best level of investment return consistent with the defined risk parameters as embodied in the strategic benchmark. However, the Council recognises that Social, Ethical and Environmental issues are factors to be taken into consideration in assessing investments. The investment managers have confirmed they pay due attention to these factors in the selection, retention and realisation of investments. The Pensions Committee will monitor the managers' statements and activities in this regard.

3.26 LAPFF officers are coming to present on their work and engagement to the Committee at this meeting. Explaining the support that the LAPFF has given to resolution seeking companies to develop strategic plans consistent with action being taken to manage climate change.

3.27 Research into actions by other local authority's funds indicates that engagement remains the most common approach to managing carbon risks, with measurement of carbon "footprint" and plans to reduce "footprint" also in use. The Fund is currently getting quotes from service providers to provide the service of measuring carbon foot print of the Fund in order to manage the plans of reducing footprint of the Fund.

3.28 At the end of December 2016, the Fund had investments of some £57.5m in fossil fuels, this represent 4.4% of the Fund total value of £1.312bn. The passive UK Equity portfolio had major share with £32.8m invested in fossil fuels.

## 4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 There are no significant financial impacts of this paper.

## 5. LEGAL COMMENTS

5.1 The Committee has legal responsibilities for the prudent and effective stewardship of the Pension Fund and a clear fiduciary duty in the performance of its functions. The LGPS (Management and Investment of Funds) Regulations 2016 require Administering Authorities to state the extent to which they comply with the Guidance given by the Secretary of State. In accordance with regulation 7(2)(e) the authority must set out in its Investment Strategy Statement, its policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments.

5.2 Updated Statutory Guidance on preparing and maintaining an investment strategy statement was published on the 15th September 2016. Having a policy in place covering the authority's approach to ethical, social and governance issues will enable to authority to meet its statutory duties in this regard. The recommendations discussed in this report are in line with both the Committee's terms of reference and legal responsibilities.

5.3 When performing its functions as administrator of the LBTH pension fund, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector duty).

## 6. ONE TOWER HAMLETS CONSIDERATIONS

6.1 The management of the Fund's investment portfolio and the investment returns that the Fund is able to deliver have significant financial implications, not just for the Fund itself but also on the Fund's employers in terms of the level of contributions they are required to make to meet the Fund's pension undertakings, which are underwritten by statute.

6.2 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.

6.3 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

## 7. BEST VALUE (BV) IMPLICATIONS

7.1 The costs involved will very much depend on future decisions made around investment strategy. Climate change risk will be integrated into the forthcoming new Investment Strategy Statement to ensure that it is considered as part of the Committee's asset allocation decisions, rather than in isolation.

## 8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

8.1 The Fund through its participation with Local Authority Pension Fund Forum (LAPFF) supported progress towards an orderly transition to a low carbon economy. This is by actively working with other asset owners, fund managers, companies, academia, policy makers and others in investment industry.

## 9. RISK MANAGEMENT IMPLICATIONS

9.1 The Fund recognises that investment in fossil fuels and the associated exposure to potential 'stranded assets' scenarios may pose material financial risks. These risks apply not only to the Fund's investment portfolio but also, when considered on a wider scale, to long term global economic growth.

9.2 In recognising the risks that climate change and stranded assets scenarios could pose to the Fund, the Committee needs to understand where these risks might apply and how they can best be mitigated within the investment management framework within which LGPS funds operate. The recommendations provided on this report are aimed at developing both a greater understanding of the risks and a set of strategies to help mitigate them.

## 10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1 There are no crime and disorder reduction implications arising from this report.

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**Linked Reports, Appendices and Background Documents**

**Linked Report -** NONE

**Appendices - None**

**Local Government Act, 1972 Section 100D (As amended)**
**List of "Background Papers" used in the preparation of this report**

**Officer contact details for documents:**

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