Non-Executive Report of the: **PENSIONS COMMITTEE** **13 March 2019**	TOWER HAMLETS
Report of: Neville Murton - Corporate Director of Resources	**Classification:** Unrestricted
Update and Further Implementation Considerations on Sustainable and Low Carbon Investments for Tower Hamlets Pension Fund	

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

Summary

This report outlines the Funds current position on responsible investments, and discusses the Environmental, Social and Governance (ESG) issues currently dominating Pension Fund investment debate.

This report provides a broad overview of the Fund's approach to Responsible Investment (RI) across two dimensions; sustainable investment and effective stewardship. The report considers applicable legislation and guidance and best practice across the areas where the Fund could look to change and improve its approach. The report will be considered alongside a discursive session with the Fund Investment Consultant and Independent Advisor.

At the November 2018 meeting of the Pensions Committee, officers presented the results of a carbon footprint analysis of the Fund's listed equity assets.

The results highlighted that the Fund's equity assets were in aggregate approximately 38% less carbon intensive than the Fund benchmark.

However, mandate-specific carbon footprinting analysis showed a wide variation between active and passive implementation routes.

Recommendations:

The Pensions Committee is recommended to:

i) Maintain the Fund's current engagement activities which the Local Authority Pension Fund Forum (LAPFF) carry out on behalf of the Fund;

ii) Consider and approve disinvestment or redemption of Passive Global Equities;

iii) Consider increasing Fund asset allocation to Low Carbon Strategy to 20% of the Fund assets;

iv) Consider and approve asset allocations to RBC core global equity mandate (5%). Renewable Energy Strategy (5%) and possibly Infrastructure (5%); and

v) Delegate authorities to the Corporate Director, Resources and the Interim Divisional Director of Finance in consultation with the Chair and Deputy Chair of the Committee to determine which Renewable Energy Strategy and Infrastructure

Fund are appropriate for the fund in meeting its liabilities.

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 £1.5billion 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 statutory pension obligations.

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 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 LGPS investment management framework. 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 investment strategy decisions. 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 from using 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 Not to change strategy.

3. DETAILS OF REPORT

3.1 A key distinction should be made between socially responsible investments (SRI) and responsible investment (RI). RI is an approach that takes into account ESG factors and considers how the risks posed by the non-sustainability of companies invested in can impact the financial wellbeing of the Fund. Therefore responsible investment is driven more by how sustainable factors can have financial consequences rather than ethical or moral implications which can be very subjective.

3.2 There is increasing pressure being placed on Pension Funds by stakeholders to ensure that ESG factors are considered when making investment decisions. This pressure is coming from lobby groups, other stakeholders, the Bank of England and even the Pensions Regulator has warned that savers face long term financial risks because trustees are failing to take climate change, responsible business practices and corporate governance into account when making investments.

RESPONSIBLE INVESTMENT

3.3 No consistent definition of Responsible Investment exists and the term has a variety of meanings. The UN Principles for Responsible Investment (PRI) uses a definition of responsible investment that emphasises the health of the market as a whole: "Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance factors, and of the long-term health and stability of the market as a whole. It recognises that the generation of long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems."

3.4 The subject of Responsible Investment has been considered by the Pensions Committee on a number of occasions. The Committee has aimed to reduce the extent to which the Fund is exposed to financial risk associated with Environmental, Social and Governance (ESG) factors but also to effectively express its views on ESG issues through the exercise of the Fund's voting rights and enhance the Fund's approach to engagement with its investee companies more generally. However, the rapid changes currently taking place across the sector have raised a number of questions about how RI approaches can best be delivered through the new pooled structures.

SUSTAINABLE INVESTING

3.5 The term 'sustainable investing' refers to the idea that investors should recognise the potential financial impact of (ESG) factors in investment decision making. Under the LGPS (Investment and Management of Funds) Regulations 2016, the Fund is required to meet a minimum standard with regards to its position on sustainable investment and must disclose, in its Investment Strategy Statement, how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments.

3.6 The extent of investors' fiduciary duty with regards to ESG factors has been the subject of considerable debate in recent years. The Law Commission published a report, 'Fiduciary Duties of Investment Intermediaries', which offered guidance to investors on the circumstances under which they might have a fiduciary duty to consider ESG factors. A recent update to the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018, although not directly applicable to the LGPS, provided a further steer on the Government's view of the duties of trustees. It is therefore clear that investors are expected to take account of ESG factors where these are financially material and that such a stance should be assumed to be part of any compliant approach to this subject.

3.7 The Tower Hamlets Pension Fund takes an active approach to sustainable investing. The core legislative requirements are met via a clear statement on its approach to ESG factors within the Investment Strategy Statement, stating that the Fund will explicitly consider ESG factors in its decision making where these are financially material. The Fund, however, also takes a more active stance by using dedicated ESG reporting on a triennial basis to track its exposure to fossil fuel reserves and carbon emissions, and towards the of 2018 set a target to reduce its exposure by 50% over 6 years.

3.8 The Fund could potentially look to improve this approach by acquiring a better understanding of some of its non-carbon related ESG exposures, and lending its support to broader industry initiatives, potentially through the Local Authority Pension Fund Forum (LAPFF).

MERCER'S ESG RATING SCALE

3.9 ESG ratings are undertaken by Mercer's global manager research team. They are on a scale from 1 (highest) to 4 (lowest) and assess how well active managers integrate ESG factors into their investment processes. Ratings for passive equity strategies differentiate how well firms undertake their stewardship activities such as voting, engagement, industry collaboration and reporting.

Ratings	ESG1	ESG2	ESG3	ESG4
Active	Leader in the integration of ESG factors and active ownership into core processes .	Less advanced than ESG1 investors but with moderate integration of ESG factors and active ownership.	Limited progress with respect to ESG integration and active ownership, albeit with signs of potential improvement.	Little or no integration of ESG factors or active ownership into core processes and no indication of future change.
Ratings	**ESGp1**	**ESGp2**	**ESGp3**	**ESGp4**
Passive	Leaders in Voting & Engagement across ESG topics with active ownership activities and ESG initiatives undertaken consistently at a global level	Strong approach to Voting & Engagement across ESG topics and initiatives at a regional level, with progress made at a global level	Focus tends to be on Voting & Engagement on governance topic only, more regionally focused with less evidence of other internal ESG initiatives	Little or no initiatives taken developing a Voting & Engagement capability, with little progress made other ESG initiatives

3.10 The below table compares the ESG score for each of the Fund's mandate compared to Mercers universe average scores (where appropriate). Mercer has shown the ESG ratings for the RBC Global Equity Fossil Fuel Free and RBC Core Global Equity funds, as requested by Officers, for information.

3.11 Mercer's conclusion on the ESG ratings for the Fund's investments were, on average, more favourably rated than the average ESG rating for the corresponding asset classes.

Asset Class (manager)	Strategic Asset Allocation (%)	ESG Rating	Mercer Universe Average
Global Equities Active (Baillie Gifford)	20%	2.0	3.0
Passive Global Equities (L&G)	15%	1.0	3.0
Passive Low Carbon Global Equities (L&G)	15%	1.0	3.0
Global Equity Fossil Fuel Free (RBC)	-	1.0	3.0
Core Global Equity (RBC)	-	1.0	3.0
Diversified Growth (Baillie Gifford)	10%	4.0	3.8
Diversified Growth (Ruffer)	10%	3.0	3.8
Multi Asset Credit (CQS)	6%	4.0	3.4
Absolute Return Bonds (Insight)	3%	2.0	3.5
Absolute Return Bonds (Goldman Sachs)	3%	3.0	3.5
Passive UK Index-Linked Gilts (L&G)	6%	N/A	N/A
UK Property (Schroders)	12%	3.0	2.9

• Where the ESG Weighted Average is; Green (better than the universe), Red (behind the universe)

The Fund's investments are, on average, more favourably rated than the average ESG rating for the corresponding asset classes

Climate Change and Fossil Fuel

3.12 A number of lobby groups have been pressuring LGPS funds including LBTHPF to divest or have a plan to divest from fossil fuels on the basis that coal, oil and gas consumption are contributing heavily to climate change and global warming to which some scientists have attributed responsibility for the increase in the incidence of natural disasters such as storms, floods heatwaves in recent times.

3.13 LGPS funds have continued to come under criticism for investing in controversial stocks such as oil, tobacco, alcohol producers, gambling firms, and payday lenders. Some local authority including Tower Hamlets Pension Fund, the London Boroughs of Islington, Haringey, Southwark and the Environment Agency have committed to reducing their exposure to carbon and some have gone on to state when they expect to be fully divested.

3.14 However many LGPS funds have opted to retain their investments in companies with significant carbon footprints on the basis that being invested enables them to continue to lobby the companies to reduce their CO2 emissions. The LAPFF working with a group of other investors successfully lobbied Shell to concede to a number of demands on climate change by lodging a shareholder resolution. The cost of immediate divestment will be substantial based on the returns on some of the companies alleged to be ESG offenders.

3.15 The share price returns excluding dividends for companies such as Tesco, VW, BP, and Shell have been substantial over the last two years. If they had been completely excluded from LBTHPF portfolio, the funds returns would have been financially impacted.

Carbon and Environmental Footprints Outcome

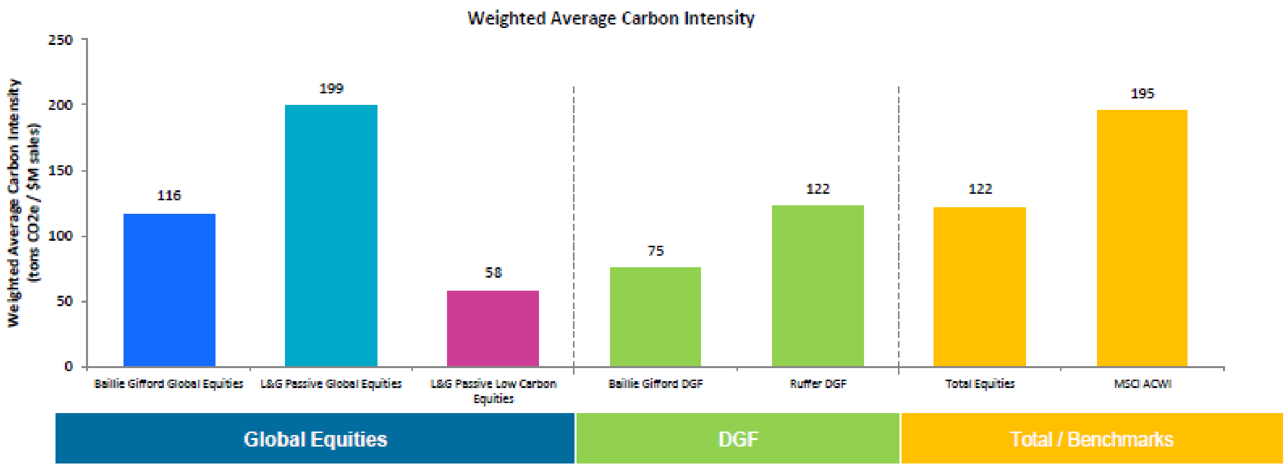
3.16 A review of Environmental, Social and Governance (ESG) compliance in summer 2018 which was then reported to the Committee at its November 2018 meeting. The carbon footprint analysis measures the greenhouse gas emissions produced within each equity portfolio (per tonnage) in relation to their annual revenue, demonstrating how much of their return is determined by activities which emit carbon dioxide to enables comparison between companies, irrespective of size or geography.

3.17 This was done by measuring the carbon footprint of each individual asset holding, encompassing both direct and first tier indirect impacts. Direct impacts are those which result from a company's own vehicles, operations and waste. First tier indirect impacts occur as a result of a company procuring services from within their supply chain.

3.18 The carbon footprint analysis was carried out on the Fund equity holdings with LGIM (FTSE), LGIM (MSCI) and BG (GE) MSCI by the Fund Investment Consultant - Mercer as at 31 March 2017 and 31 March 2018. This demonstrated that the total Fund was 31% more carbon efficient than the benchmark as at 31 March 2017 and 38% lower in carbon exposure relative to the MSCI ACWI.

3.19 It can be seen from the below graph produced by Mercer that the overall Equity portfolio exhibits 122tCO2e which is approximately 38% lower carbon exposure relative to the MSCI ACWI benchmark of 195tCO2e and each Equity mandate held by the Fund contributes to carbon efficiency of the Fund as follows:

CARBON FOOTPRINT ANALYSIS
31 MARCH 2018 PORTFOLIO



3.20 As expected the weighted average carbon intensity (WACI) is concentrated within the below three listed sectors. The largest sector contributions from our Fund to carbon intensity as at 31st March 2018 were:

i) Materials holdings: c.23%
ii) Energy holdings: c.20%
iii) Utilities holdings: c17%

3.21 The table below summarises the carbon exposure of each portfolio with equity holdings as at 31st March 2018. Please note that Ruffer and Baillie Gifford DGFs do not have a broad equity market benchmark.

Portfolio	**Total CO2 Footprint per £m holding (tCo2e/£m revenue)**	**Benchmark CO2 Footprint per £m holding (tCo2e/£m revenue)**	**Variance**	**Comment in relation to the benchmark – MSCI ACWI**
Baillie Gifford GE	116	195	-79 or 40%	More efficient
LGIM Passive GE	199	195	+4 or 102%	Less efficient
LGIM Passive LC	58	195	-137 or 70%	Very efficient
Baillie Gifford DGF	75	195	-120 or 61%	More efficient
Ruffer DGF	122	195	-73 or 37%	More efficient
Total Fund Equities	122	195	-73 or 37%	More efficient

3.22 As LGIM Passive Global Equities demonstrates very similar carbon intensity to the benchmark, Officers suggested to Mercer to consider RBC products for the LCIV platform. These are RBC Global Equity fund (available on the London CIV) and the RBC Global Equity ex. Fossil Fuels Fund (which could be made available). Both funds are ESG1 rated by Mercer.

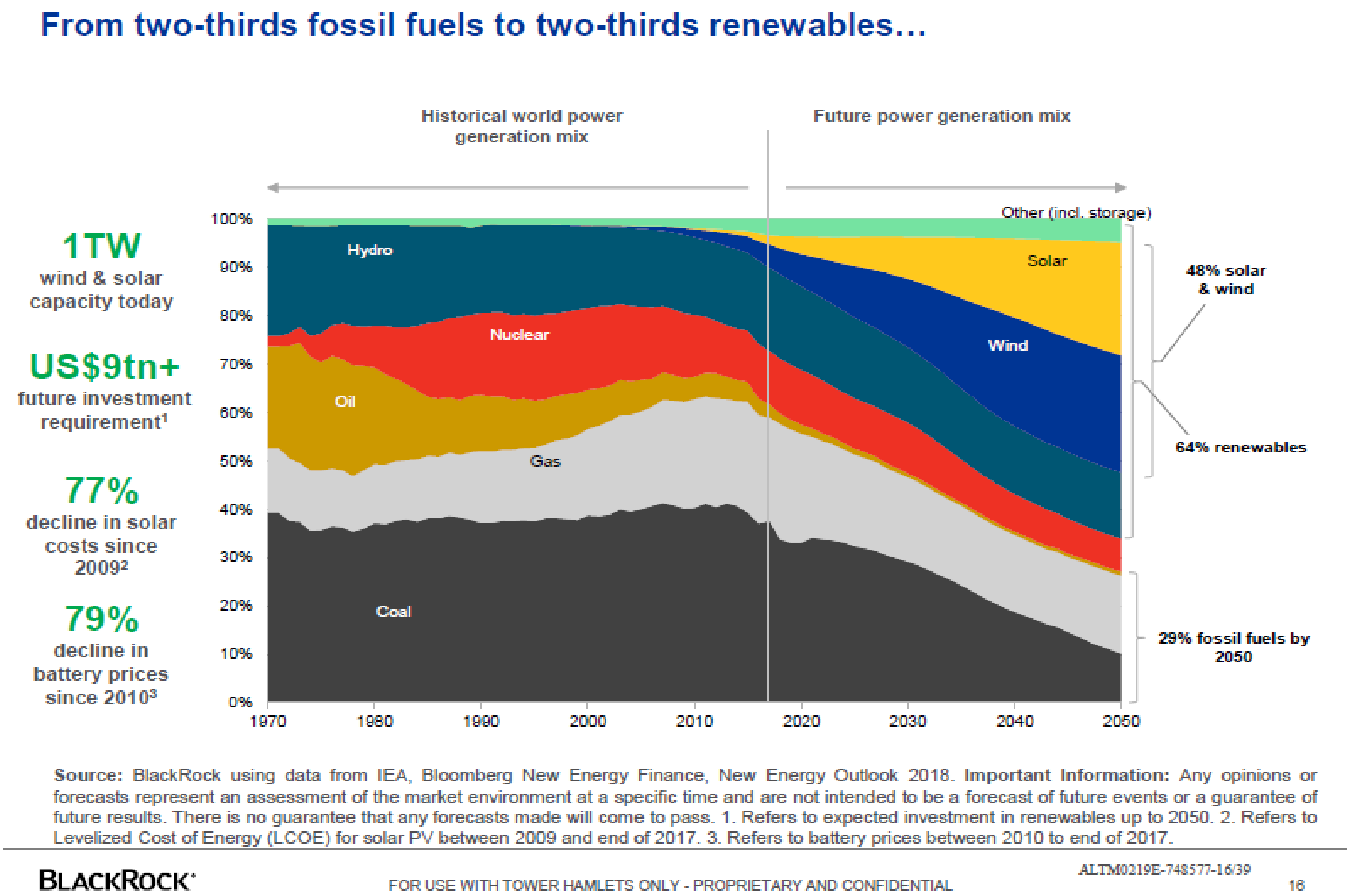
3.23 Mercer advises RBC's approach to investing has similarities to Baillie Gifford, in that it has a bias towards stocks with high growth potential. The RBC Core Global Equities portfolio demonstrates a significant reduction in carbon intensity of 54% vs. the MSCI ACWI benchmark. And the RBC Global Equity Fossil Fuel Free portfolio demonstrates a further significant reduction in carbon intensity of 75% vs. the MSCI ACWI benchmark.

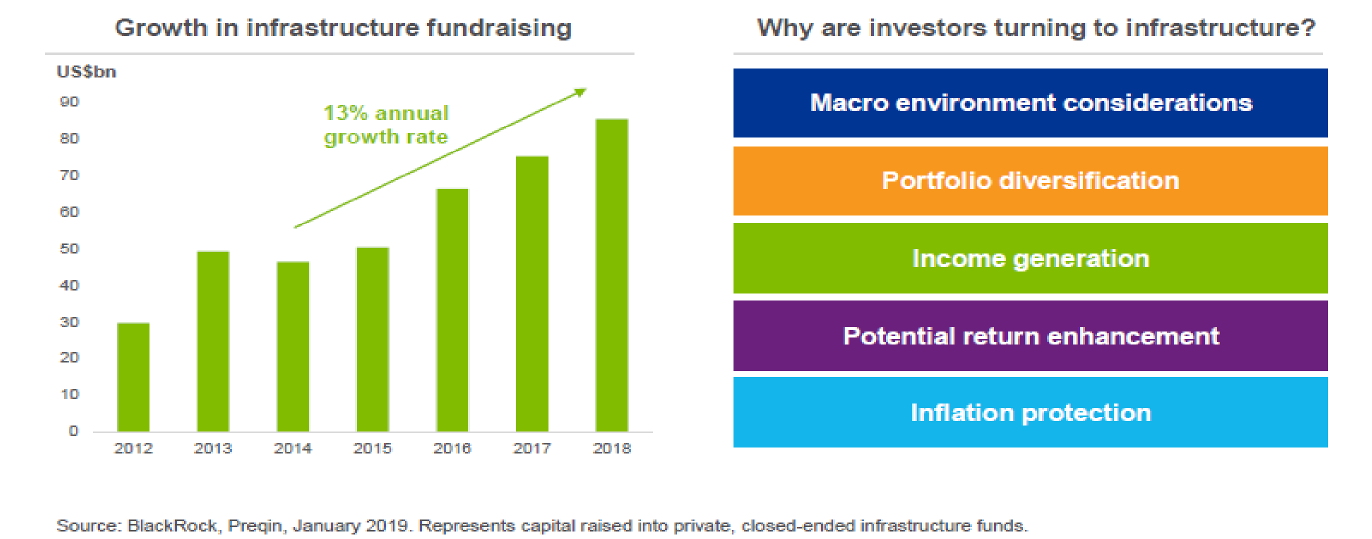
3.24 This suggested that a re-allocation away from LGIM Passive Global Equities to either RBC funds would be expected to improve the carbon intensity of Tower Hamlets Fund further, given that both RBC funds exhibit relatively low carbon intensity.

3.25 The Fund may wish to delay the transfer to RBC funds until after the investment strategy review is conducted in March 2019, as this will consider the overall allocation to equities and the appropriate structure of the equity portfolio. Moreover the Fund has an Equity Protection Strategy in place and some £142m of the LGIM Passive Global Equity mandate was redeemed to support the collateralisation management of this programme.

Renewable Energy - Infrastructure

3.26 Further to the training Committee members have had, this is just a quick reminder that Infrastructure offers a broad investment opportunity and a number of key investor benefits. Investors are increasing allocations to infrastructure, with capital raised growing 13% annually over the past five years. Motivation for infrastructure allocation is multi-faceted, but led by diversification, income generation and potential for return enhancement. And also that Tower Hamlets Pension Fund focus to invest in renewable energy is to contribute to the Fund carbon intensity improvement as shown in the chart below.





3.27 At the November 2018 meeting of the Pensions Committee, Fund officer presented the results of carbon footprinting analysis of the Fund's listed equity exposures. The results highlighted that the Fund's equity assets were in aggregate approximately 38% less carbon intensive than the MSCI ACWI benchmark. However, mandate-specific carbon footprinting analysis showed a wide variation across different benchmarks and between active and passive implementation routes.

Tower Hamlets Decarbonisation Approach to Fossil Fuel Issues

3.28 Tower Hamlets approach is to reduce the carbon intensity of the Fund over time as an exclusionary approach removes the potential to positively influence companies and the Fund Investment consultant prefers a decarbonisation approach.

3.29 The Pensions Committee has a legal duty to ensure that pension liabilities due to members of the scheme are fulfilled and to ensure the fund is sustainable. In the three years to March 2016, the funding level of the Pension Fund increased from 71.8% to 82.7%, so this demonstrates that the fund is on track to meet its future liabilities.

3.30 A number of the Tower Hamlets Pension Fund investments are with the London CIV as part of the investment costs reduction by pooling investments across local authority's funds. The London CIV is exploring the potential for low carbon funds but these investments vehicles are not yet in place. When these funds are available the Committee will proactively look to see if there are opportunities to move investments into those funds.

3.31 There is no recommendation that the LBTHPF divest fully from fossil fuels at this point. It is however recommended that Members should continue reducing fossil fuel investments by deploying assets to alternative investments such as renewable energy, infrastructure, long lease asset and some allocation more into Low Carbon Target or into ex Fossil Fuel Fund, with the aim of reducing carbon intensity of the Fund significantly by 2022. This approach is known as Fund decarbonisation. The benefits of this approach include:

a) The portfolio will be less susceptible to increasing carbon pricing, stranded assets and/or related regulation.
b) It supports the flow of capital to a resilient low-carbon economy and may help to address the market mispricing of carbon.
c) Produces a market signal that incentivises companies to develop and invest in low carbon and clean technologies, influences policymakers and also helps to catalyse a new standard for other institutional investors.

3.32 The below recommendations were agreed:

a) A target for overall Equity portfolio to be 60% lower in carbon exposure relative to the MSCI ACWI benchmark in 5 years and or;

b) A target to reduce the Fund's relative exposure to future emissions from fossil fuel reserves (measured in tCO_2e – million tonnes of CO_2 emissions) by 50% over 2 valuation cycles (6 years);

c) To measure the carbon reduction relative to the Fund's position as at March 2018 (138 tCO_2e) and adjusted for Assets Under Management; and

d) To review target periodically to ensure that it remains consistent with the risks associated with investment in carbon assets and with the Committee's fiduciary duties.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 The performance of the Fund affects the level of contribution to the Fund required for employer's contribution (i.e. the Council's contribution towards employees' pensions).

4.2 The returns achieved by the Fund for the three years beginning 1 April 2016 will impact on the next valuation as at 31 March 2019. It is important to ensure that any direct investment in ESG investment does not have a financial impact on the Fund.

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 carrying out its functions, 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.

Linked Reports, Appendices and Background Documents

Linked Report - None

Appendices – Appendix 1: Past Activities on Climate Change Issue

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

- As listed above as appendices

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