Hackney

REPORT OF THE GROUP DIRECTOR, CORPORATE FINANCE AND RESOURCES		
INVESTMENT STRATEGY STATEMENT **Pensions Committee** **24th January 2017**	**Classification** **PUBLIC** **Ward(s) affected** **ALL**	**Enclosures** **Three**

1. INTRODUCTION

1.1 This report introduces an updated draft of the new Investment Strategy Statement, to be introduced from 1st April 2017 in line with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016. It also sets out for the consideration of the Committee a proposed commitment for the Fund to reduce its exposure to fossil fuel reserves.

2. RECOMMENDATIONS

2.1 The Committee is recommended to:

- **Consider the updated draft of the Investment Strategy Statement and approve for consultation with stakeholders (The Pension Board/Investment Managers/The London CIV) ahead of final approval for publication at the Pensions Committee meeting on 29th March 2017.**
- **Approve the proposed commitment for the Fund to reduce its exposure to fossil fuel reserves for inclusion in the Investment Strategy Statement.**

3. RELATED DECISIONS

3.1 Pensions Committee 6th December 2016 – Investment Strategy Development

3.2 Pensions Committee 18th November 2015 – Investment Strategy

3.2 Pensions Committee 27th June 2016 – Training Session – Active and Passive Investment Approaches

1. COMMENTS OF THE GROUP DIRECTOR, CORPORATE FINANCE AND RESOURCES

4.1 This paper sets out an initial draft of the Investment Strategy Statement (ISS), following the discussions with the Fund's Investment Consultant at the Pensions Committee Strategy meeting in December 2016. The draft Strategy Statement has been set out to reflect the funding position of the Fund and the investment beliefs of the Committee.

4.2 Adherence to the principles set out in the Strategy will enable to the Fund to take an ordered and prudent approach to the management of its assets, helping to manage the long term costs associated with the Pension Fund. The full consideration and approval of the ISS helps to ensure that the Pensions Committee are fulfilling their responsibilities as quasi Trustees of the Fund and that the Fund's investment objectives and policies are clearly set out in line with the Local Government Pensions Scheme (Management and Investment of Funds) Regulations 2016.

4.3 Climate change risk is being integrated into the new Investment Strategy Statement to ensure that it is considered as part of the Committee's asset allocation decisions, rather than in isolation. Possible costs that could be incurred through approval of the recommendations detailed above include possible additional investment management costs; however, any such costs would need to be considered against the potential for risk mitigation and the performance of the portfolio as a whole

5. COMMENTS OF THE DIRECTOR, LEGAL

5.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 came into force on 1st November 2016. These Regulations represent an update to the LGPS (Management and Investment of Funds) Regulations 2009 and make a number of changes, including dispensing with the current, explicit limits on specified types of investment and instead charging administering authorities with determining the appropriate mix of investments for their funds.

5.2 Regulation 7 of the 2016 Regulations requires the Administering Authority to formulate an Investment Strategy Statement (ISS) in line with guidance published by the Secretary of State. The first such statement must be published by 1st April 2017. Broad powers allow the Government to intervene if an Administering Authority does not publish and maintain an ISS as set out in the guidance.

5.3 This paper sets out an initial draft of the ISS (at Appendix 1) for review ahead of the deadline for final approval at the Pensions Committee on 29th March 2017. Both regulations and guidance have been published with this report as Appendices 2 and 3 respectively.

5.4 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 2016 Regulations require Administering Authorities to state how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments. The proposed statement on carbon risk management assists the Committee in fulfilling this duty.

5.5 There are no immediate legal implications arising from this report.

2. INVESTMENT STRATEGY STATEMENT

6.1 New regulations affecting LGPS funds in England and Wales came into force on 1st November 2016. The new Regulations dispense with the current, explicit limits on specified types of investment and, instead, charge administering authorities with determining the appropriate mix of investments for their funds. The quid pro quo for more freedom in the formulation of investment strategies is an obligation upon administering authorities to adhere to official guidance and broad powers allowing the Government to intervene if they do not.

6.2 Regulation 7 of the new Regulations sets out for Administering Authorities what must be included within the new ISS. Items to be included are as follows:

- 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 assessed 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 and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
- the authority's policy on the exercise of the rights (including voting rights) attaching to investments

6.3 A draft of Hackney's ISS is attached at Appendix 1 to this report for discussion with the Fund's Investment Consultant at the Committee meeting. A further paper will be brought for discussion at the meeting, setting out Hymans Robertson's recommendations in respect of the Investment Strategy. A final draft of the ISS will be brought to the meeting in March for approval for publication.

3. COMMITMENT TO PORTFOLIO DECARBONISATION

7.1 In January 2016 the Pensions Committee held a strategy meeting to consider in detail the Fund's approach to investment in fossil fuels and management of the financial risks posed by climate change. At this meeting, the Committee considered and approved a set of recommendations reflecting both its recognition of these risks and a strengthened commitment to factor them into its investment approach. One such recommendation was to develop a policy statement regarding the Fund's approach to fossil fuel investment for inclusion as a section within the new Investment Strategy Statement (ISS). This has now been completed, and this report sets out the text of that statement for approval by the Committee.

7.2 The Commitment set out within the statement has been informed by the Carbon Risk Audit carried out by Trucost in summer 2016. This assessed the operational carbon footprint and exposure to fossil fuel reserves of the Fund's equity portfolio, setting out where the Fund is most exposed in terms of assets at risk of stranding. The results of this assessment suggest that the greatest risk with regards to potentially stranded assets is concentrated in companies with coal reserves within the passive UK equity (managed by UBS) and active Emerging Markets equity (managed by RBS) portfolios; however some concentration of oil and gas reserves can be found within the two active Global Equity mandates (managed by Lazard and Wellington).

7.3 In considering how the risks posed by stranded assets can best be mitigated within the investment management framework within which LGPS funds operate, and after taking proper advice, it is considered appropriate to propose the following quantifiable, time-bound target for a reduction in the Fund's exposure to future fossil fuel emissions. The Fund should:

- Reduce the its relative exposure to future emissions from fossil fuel reserves (measured in $MtCO_2e$ – million tonnes of CO_2 emissions) by 50% over 2 valuation cycles (6 years)
- Measure the reduction relative to the Fund's position as at July 2016 (7.11$MtCO_2e$) and adjusted for Assets Under Management (£AUM)

7.4 This proposal is an initial step in ensuring that the Fund is prepared for transition to a low carbon economy. It clearly sets out the timeframe for decarbonisation and defines how it is to be measured, making it the most ambitious carbon reduction target amongst the London LGPS funds. The 2016 audit measured exposure to future emissions across the whole of the Fund's equity portfolio, making no distinction between holdings in segregated mandates and those in pooled funds. The analysis also covers all sectors, allowing as comprehensive an assessment as possible of where the Fund is exposed to the risk of stranded assets. Clearly this analysis will be repeated in the future to allow the Fund to measure progress against its target; it is hoped to extend the scope in future to also cover fixed income assets.

7.5 Plans for the implementation of the proposal focus on the Committee's role in asset allocation and strategy setting. The Fund is working with the London CIV to ensure that suitable strategies are made available, with a focus on investing sustainably to ensure long term returns for the Fund. Consideration has also been given in setting the strategy to how exposure to areas of higher carbon risk can be reduced. The Fund will also engage with its managers and the London CIV on specific areas of carbon risk where required.

7.6 The Fund wishes to consider its overall risk of exposure to future emissions, and has therefore chosen not to entirely exclude specific sectors. This helps to ensure that unreasonable limits are not placed on manager decision making with regards to individual investee companies. However, the Fund does expect its active managers to consider carbon risk in their decision making and will engage with managers and the London CIV to ensure that the strategies the Fund invests in continue to meet its needs.

7.7 The Fund will review this target periodically to ensure that it still reflects the risks of investing in carbon assets and remains in line with the Committee's fiduciary duties. Periodic review will also help the Fund to plan over the long term and determine future steps in managing its exposure to carbon risk.

7.5 The proposed text of the statement is set out below; the Committee are recommended to approve the statement for inclusion within the wider Investment Strategy Statement.

Approach to Carbon Risk

Where appropriate, the Committee considers how it wishes to approach specific ESG factors in the context of its role in asset allocation and investment strategy setting. Taking into account the ratification in October 2016 of the Paris Agreement, the Committee considers that significant exposure to fossil fuel reserves within the Fund's portfolio could pose a material financial risk. In summer 2016, Trucost were commissioned to produce a Carbon Risk Audit for the Fund, quantifying the Fund's exposure through its equity portfolio to fossil fuel reserves and power generation and where the greatest risks lie.

Having taken into account the risks associated with exposure to fossil fuel reserves, the Committee has approved a target to:

- Reduce the Fund's relative exposure to future emissions from fossil fuel reserves (measured in $MtCO_2e$ – million tonnes of CO_2 emissions) by 50% over 2 valuation cycles (6 years)
- Measure the reduction relative to the Fund's position as at July 2016 ($7.11MtCO_2e$) and adjusted for Assets Under Management (£AUM)

The target will be periodically reviewed to ensure that it remains consistent with the risks associated with investment in carbon assets and with the Committee's fiduciary duties.

The Committee considers exposure to carbon risk in the context of its role in asset allocation and investment strategy setting. Consideration has therefore been given in setting the Fund's Investment Strategy to how this objective can be achieved within a pooled investment structure and the Committee, having taken professional advice, will work with the London CIV to ensure that suitable strategies are made available.

Where necessary, the Fund will also engage with its Investment Managers or the London CIV to address specific areas of carbon risk. The Fund expects its investment managers to integrate financially material ESG factors into their investment analysis and decision making and may engage with managers and the London CIV to ensure that the strategies it invests in are appropriate for its needs. However, the Fund does not at this time operate a blanket exclusion policy in respect of specific sectors or companies.

Ian Williams
Group Director, Finance and Corporate Resources

Report Originating Officers: Rachel Cowburn ☎020-8356 2630
Financial considerations: Michael Honeysett ☎020-8356 3332
Legal comments: Stephen Rix ☎020-8356 6122

Appendices

Appendix 1 – Exempt - Draft Investment Strategy Statement
Appendix 2 – Local Government Pensions Scheme (Management and Investment of Funds) Regulations 2016
Appendix 3 – DCLG Guidance on Preparing and Maintaining an Investment Strategy Statement

By Virtue of Paragraph 3 Part 1 of schedule 12A of the Local Government Act 1972 appendix 1 is exempt because it contains Information relating to the financial or business affairs of any particular person (including the authority holding the information) and it is considered that the public interest in maintaining the exemption outweighs the public interest in disclosing the information.