Hackney

REPORT OF THE GROUP DIRECTOR, FINANCE AND CORPORATE RESOURCES		
Exposure to Fossil Fuels – Review of Progress **Pensions Committee** **26th March 2019**	**Classification** **PUBLIC** **Ward(s) affected** **ALL**	**Enclosures:** **Three**

1. INTRODUCTION

1.1 This report provides the Pensions Committee with an update on implementation of the Fund's carbon reduction target. The report provides an overview of the introduction of the target in 2016/17, considers how changes to the Fund's asset allocation since 2016/17 have helped reduce exposure and sets out plans for a formal review of progress during 2019 along with further measures in the future.

1.2 As set out in this report, the formal review will include an interim carbon risk review to be carried out by Trucost, the same provider we used to carry out our initial analysis, thus allowing for comparability between the original and interim reports. The review will be carried out as at 30th June 2019 allowing the results to be considered within the upcoming strategy setting exercise that will take place early in 2020. The Committee will consider the results of the interim review as well as wider information and updates on the impact of fossil fuels, such as the IPCC special report on the impacts of global warming of 1.5 °C.

1.3 The Committee will continue to engage with fossil fuel companies via organisations such as LAPFF in order to influence their future strategies with the aim to influence a wider move from fossil fuels in the world economy.

1.4 In addition, the Fund wishes to explore ways in which we can support progress towards a low carbon economy through positive investment in renewable energy and associated technologies, in line with the recent reports that state that a rapid and orderly transition to other energy sources is increasingly urgent. We believe that investing in the suppliers and technologies helping to drive change is a potential way for the Fund to actually contribute to the transition. The Committee will therefore use the next investment strategy review to consider how the Fund could make a positive contribution to the transition to a low carbon economy through investment in renewable energy, whilst meeting its own strategic investment requirements.

2. RECOMMENDATIONS

2.1 **The Pensions Committee is recommended to:**
- **Note the report**
- **Approve the proposal to commission a formal interim carbon risk audit at an expected cost of £10-£20k**

3. RELATED DECISIONS

- Pensions Committee (24th January 2017) – Investment Strategy Statement

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

4.1 The Pensions Committee is responsible for the management of the Pension Fund and are therefore responsible for the management of approximately £1.5 billion worth of assets and for ensuring the effective and efficient running of the Fund. The level of investment returns achieved by the Fund has significant financial implications, not solely for the Fund itself but also for the Fund's employers, who must make up any shortfall with additional contributions

4.2 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

4.3 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 Fund's approach to carbon reduction is intended to ensure that the risks of fossil fuel investment are appropriately managed whilst ensuring that the Fund retains an appropriately broad investment universe.

5. COMMENTS OF THE DIRECTOR OF LEGAL AND GOVERNANCE

5.1. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 Regulation 7 requires the Administering Authorities to publish and maintain an Investment Strategy Statement which includes, amongst other items, details of 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.

5.2. The Hackney Pension Fund's Investment Strategy Statement includes climate change as a material financial factor to be taken into account in the Pensions Committee's decision making. This position with regards to carbon risk is supported by the Law Commission, whose guidance clarifies that funds must have regard to all material financial factors when making investment decisions and by the Pensions Regulator, who regards climate risk as a financial factor affecting the long term sustainability of pension scheme investments. The Regulator has stated that climate change should be taken into account in the development and implementation of pension funds' investment strategies.

5.3. This paper sets out how the Committee approaches the inclusion of climate change as a factor within its investment decision making and how it is taken into account within the Fund's Investment Strategy Statement. This helps to demonstrate compliance with the Regulations detailed above, as well as guidance provided by the Law Commission and the Pensions Regulator.

6. BACKGROUND TO THE REPORT

6.1. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 Regulation 7 requires the Administering Authorities to publish and maintain an Investment Strategy Statement which includes, amongst other items, details of 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.

6.2. The Hackney Pension Fund's policy, based on guidance from the Law Commission, is to take into account any factors which are financially material and affect the financial sustainability of investments. These may include Environmental, Social and Governance (ESG) factors, such as carbon risk. The Fund does not make investment decisions on the basis of non-financial factors.

6.3. The Pensions Regulator specifically references climate risk in its Defined Benefit investment guidance, stating that 'Most investments in pension schemes are long-term and are therefore exposed to long-term financial risks. These potentially include risks relating to factors such as climate change, unsustainable business practices, and unsound corporate governance. Despite the long-term nature of investments, these risks could be financially significant, both over the short and longer term'

6.4. Taking all of the above together, the Committee considers it appropriate to take climate risk into account as a material financial risk within its investment strategy. The remainder of the paper sets out actions taken by the Committee to address this risk.

7. INITIAL STRATEGY MEETING

7.1. The Pensions Committee began its in depth consideration of carbon exposure in early 2016. In January 2016, the Pensions Committee held an initial 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

7.2. The recommendations made are set out below along with an update on progress:

Recommendation	Progress made
Develop a policy statement regarding the London Borough of Hackney's approach to fossil fuel investment with a view to inclusion as a section within the new Investment Strategy Statement (ISS), which will replace the current Statement of Investment Principles.	Complete – this was included in the Investment Strategy Statement introduced in March 2017. A copy of the relevant section of the ISS can be found at Appendix 2.
Agree to monitor carbon risk within the London Borough of Hackney Pension Fund and to appoint a specialist contractor to conduct a carbon footprint of the Fund at an estimated cost of between £5k to £20k	Complete – completed in summer 2016, with a follow-up exercise now planned for summer 2019. This is considered in more detail in Section 8
Review options for the Pension Fund's passive UK equity mandate	Complete – the Fund made a £150m allocation to BlackRock's MSCI Low Carbon Target Fund in May 2018. The Committee continues to review the Fund's passive equity exposure and the balance between active and passive investing.
Continue engagement activities with the Fund's investment managers on their approach to fossil fuel and to promote consideration of	Ongoing – All managers are asked about how carbon risk is incorporated into their decision making process. We also receive regular

climate change issues with managers when making investment decisions.	engagement reporting from our active equity managers
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	Ongoing – the Fund is increasing its involvement with the Local Authority Pension Fund Forum to take a more active approach to climate change issues.
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.	Complete – the Fund has gone beyond its initial commitment, increasing 13% of Fund assets in RBC's Global Sustainable Equity Fund.
Review options for switching some of the existing property mandate into a low carbon property fund	Complete – the Fund has invested £25m in Threadneedle's Low Carbon Workplace Fund, which acquires commercial office buildings and refurbishes them to create energy efficient workplaces. Once occupied, the buildings' energy and carbon performance are monitored against standards set by the Carbon Trust, who also provide support to occupiers to help reduce their energy usage
In recognition of the financial risks posed by climate change, resolve to amend the Fund's risk register to reflect this as a risk.	Complete – carbon risk has been included in a new ESG section within the register.

7.3. As can be seen from the table above, the Fund has made considerable progress in implementing the recommendations made, within all one-off items now complete. In one case the Fund has gone significantly beyond the original recommendation, making a 13% allocation to RBC GAM's Sustainable Global Equity Strategy through the London CIV, rather than the 5% originally suggested. Where the recommendations are for iterative engagement processes, the Fund continues to work to improve the effectiveness of its engagement, particularly in light of asset pooling.

7.4. These recommendations represent the start of the Fund's journey in managing carbon risk; the Fund has since taken broader action to reduce exposure across its equity portfolio, as detailed in section 8. The management of carbon risk is now a mainstream part of the Fund's approach to risk management; the Pensions Committee recognises that, as with any other risk faced by the Fund, its management is an ongoing process. As the Fund approaches the mid-point of its 6 year target, work is therefore already beginning on how the current approach can be broadened and improved. Further details on future plans can be found in Section 9 of this report.

8. CARBON RISK AUDIT

8.1. As discussed in Section 7, one of the recommendations made was to agree to monitor carbon risk within the fund and to appoint a specialist contractor to conduct a carbon footprint of the Fund. A carbon risk audit was carried out by Trucost in summer 2016 which assessed the operational carbon footprint and exposure to fossil fuel reserves of the Fund's equity portfolio, setting out where the Fund was most exposed in terms of assets at risk of stranding. The results of this assessment suggested that the greatest risk with regards to potentially stranded assets was concentrated in companies with coal reserves within the passive UK equity and active Emerging

Markets equity portfolios; however some concentration of oil and gas reserves was found within the fund's two active Global Equity mandates. The results of the audit can be found at Appendix 3 to this report.

8.2. After considering the results of the carbon risk audit, the Pensions Committee agreed the following target for a reduction in exposure to fossil fuel reserves ("future emissions")

- 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 (7.11$MtCO_2e$) and adjusted for Assets Under Management (£AUM)

The Committee agreed that the target would be periodically reviewed to ensure that it remained consistent with the risks associated with investment in carbon assets and with the Committee's fiduciary duties. As set out in the original recommendations detailed in Section 7, it was agreed that the target would be included in the Fund's Investment Strategy Statement. A copy of the relevant section of the current Investment Strategy Statement can be found at Appendix 2. The policy aims to cut the Fund's exposure to future CO2 emissions in line with the level implied by the inter-governmental Paris Agreement's 2oC scenario

8.3. When setting its investment strategy following the 2016 valuation, the Committee considered how its carbon reduction target could be achieved within the Fund's broader investment strategy, taking into account the need to move to pooled investment structures. It was agreed that reduced exposure to reserves would be achieved primarily through planned asset allocation changes, including:

- A planned reduction in the Fund's overall equity exposure and subsequent shift towards alternative credit
- A reduction in the Fund's UK passive equity exposure, with an equivalent increase in global passive equity exposure

8.4. In agreeing specific investment strategy decisions, the Committee also took into consideration other more detailed recommendations made as part of the January 2016 strategy meeting. These included:

- Identifying a suitable low carbon global equity passive equity strategy
- Consideration of options for an active global equity investment of in a sustainability/low carbon or clean energy fund(s).
- In both cases the Committee considered it appropriate to first consider options put in place via the London CIV to help meet the Fund's asset pooling obligations.

8.5. The Fund has already taken significant action to help meet its target. May 2018 saw the completion of a significant restructure of the Fund's equity portfolio, with the Fund investing 10% (approx. £150m) of assets in Blackrock's newly created MSCI Low Carbon Target Fund, with the aim of reducing the fund's exposure to fossil fuels and carbon emissions while still accessing a wide range of global markets and minimising tracking error relative to the MSCI World. The move was funded by significantly reducing exposure to the FTSE Allshare Index, the Fund's most significant source of exposure to carbon risk. A further 13% of assets (approx. £195m) was invested in RBC GAM's Global Sustainable Equity strategy via the London CIV. The strategy aims to invest in companies with long term, sustainable revenues, with a strong focus on Environmental, Social and Governance (ESG) factors.

8.6. The table below provides a full breakdown of the changes made to the Fund's equity portfolio.

PREVIOUS MANDATE	TRANSITION ACCOUNT	TARGET MANDATE
Wellington Global Equity Segregated Mandate (£247.4m – 15.5% of fund assets)	BlackRock Transition Management (£857m)	LCIV Sustainable Global Active Equity Pooled Fund (203.5m – 13% of fund assets)
Lazard Global Equity Segregated Mandate (£247.7m – 15.5% of fund assets)-		BlackRock Global Passive Low Carbon Pooled Fund (£152.5m – 10% of fund assets)
UBS FTSE AllShare Index Tracker Pooled Fund (£361.9m – 25% of fund assets)		BlackRock Hedged MSCI World Passive Pooled Fund (£347.7m - 23% of fund assets)
		BlackRock FTSE AllShare Passive Pooled Fund (£153.3m – 10% of fund assets)

8.7. These changes have already had a significant impact on the proportion of the Fund's assets invested in companies involved in fossil fuel production. Between July 2016 and December 2018, the percentage of the Fund's assets invested in fossil fuel companies reduced from approximately 7.1% of assets to approximately 4.5% of assets. Although this analysis reflects percentage value invested rather than exposure to reserves (the Fund's chosen target metric), it does still provide a useful indication that the Fund's exposure to fossil fuel companies is materially reducing. A breakdown of exposure by company is provided at Appendix 1 to this report.

8.8. It should be noted that whilst we have also included estimated value of the stock holdings in the appendix, this is irrelevant to the target set, particularly as the value of any holdings is of course impacted by the overall fluctuations in the world's stock markets, reflecting not only company specific factors but also more general economic factors at any one time. It is not therefore a true measure of any change in the Fund's exposure to fossil fuels.

8.9. In December 2018, the Fund also made a £165m commitment to 2 private debt mandates, to be funded from the existing MSCI World Passive Pooled Fund allocation. The commitments to these mandates will be drawn down gradually over a period of approximately 2 years. BlackRock's ultra short bond fund will be used as an interim strategy to manage a proportion of funds not immediately invested rather than maintain the full existing allocation to equities.

8.10. Allocating to private debt means a shift from holding large cap listed equities (via the MSCI All World Index Tracker) to lending to mid-sized companies. As such, whilst the strategies do not operate any exclusion policies, the nature and size of the companies involved means the shift to the new strategies will result in the Pension Fund reducing its exposure to large multinational fossil fuel companies.

8.11. Shifting assets away from listed equity will affect the proportion of assets for which the Fund is able to obtain carbon footprinting data. The 2016 carbon risk audit covered the Fund's listed equities, which at the time comprised 60% of its assets. A 10% allocation to private debt will reduce this to 50%. Given the lack of quantitative data available for private debt, it is proposed that the Fund assesses the impact for this new class of assets on a qualitative basis by monitoring the nature of the underlying assets and engaging with the relevant managers. We do not expect these mandates to expose the Fund to significant carbon reserves.

9. 2019 FORMAL INTERIM ASSESSMENT

9.1. In setting its initial target, the Fund chose to use 2 valuation cycles to assess progress, suggesting an interim review in 2019, after 1 valuation cycle. This timeline aligns implementation of the carbon reduction target with overall strategy setting, allowing the Committee to consider the issue as part of its full strategy review.

9.2. Officers of the Fund have approached Trucost, who carried out the initial carbon risk audit, with a view to commissioning an interim carbon risk review. Trucost have been selected as it was felt appropriate to use the same provider to allow for comparability between the original and interim reports. It is intended that the review should include:

- A comparison of the exposure to reserves for the current listed equity portfolio against the same for the 2016 listed equity portfolio using current carbon reserves data
- An analysis by fund manager of operational emissions (Scope 1 and Scope 2) and exposure to reserves for the Fund's current listed equity and bond portfolios, relative to benchmark
- An analysis of the Fund's alignment to internationally agreed future warming scenarios

9.3. It is intended that the proposed review should be carried out as at 30th June 2019. This timeframe would allow the results to be considered within the upcoming strategy setting exercise to take place in early 2020, following the outcome of the 2019 valuation, which will be available by March 2020 at the latest. In considering its approach to carbon risk and any potential changes to the target going forward, the Committee will take into account the outcome of the interim review as well as wider information and updates on the impact of fossil fuels, such as the IPCC special report on the impacts of global warming of 1.5 °C. The Committee will also take in to consideration consider the Council's target to become carbon-free by 2050, to which the Pension Fund is aligned.

9.4. The implementation of the recommendations set out in Section 7 and the wider restructure of the Fund's equity portfolio represent the start of the Fund's journey towards the comprehensive management of carbon risk. At present, the UK and wider global economies remain heavily based on fossil fuels; as we transition to a lower carbon economy new opportunities will continue to open up. At present, the Fund considers that fully excluding fossil fuels from its investment strategy would excessively restrict its investment horizons; fossil fuel divestment is not cost or risk free and the Fund needs to balance the potential long term benefits of reduction with the risks of increased investment management costs and short to medium term losses. However, as the prevalence of fossil fuels within the wider economy reduces, these risks should also reduce, permitting further reductions in fossil fuel exposure.

9.5. The Committee also strongly believe that engagement with fossil fuel companies via organisations such as LAPFF in order to influence their future strategies should continue alongside the reductions in stock holdings in such companies. We believe that simply selling stocks, whilst reducing the fund's exposure, does not in itself achieve the impact of an overall reduction in the use of fossil fuels. Others will buy the stocks released and they may not wish to engage with the companies in order to influence the move from fossil fuel.

9.6. To date, the Fund's primary focus in terms of managing its carbon risk has been on reducing risk through targeted reduction in its exposure to fossil fuel assets. However, the Fund now also wishes to explore ways in which we can support progress towards a low carbon economy through positive investment in renewable energy and associated technologies. The publication of the Intergovernmental Panel on Climate Change (IPCC)'s report on the impacts of global warming of 1.5 °C makes clear that a rapid and orderly transition to other energy sources is increasingly urgent; whilst selective disinvestment from fossil fuel assets can be used to help manage the financial risks faced by the Fund, investing in the suppliers and technologies helping to drive change is a potential way for the Fund to actually contribute to the transition.

9.7. The Committee therefore wishes to use the next investment strategy review to consider how the Fund could make a positive contribution to the transition to a low carbon economy through investment in renewable energy, whilst meeting its own strategic investment requirements. As part of the planned interim carbon risk audit, the Committee will consider an analysis of its energy exposure against the energy requirements for 2^{o}C and 1.5^{o}C future warming scenarios. This analysis can then be used to consider how the Fund might look to align its exposure to those scenarios.

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Appendices
Appendix 1 - Fossil Fuel Holdings Breakdown
Appendix 2 - Investment Strategy Statement Excerpt
Appendix 3 - Carbon Risk Audit Presentation - EXEMPT