Hackney

REPORT OF THE GROUP DIRECTOR, FINANCE & CORPORATE RESOURCES		
Responsible Investment Policy & Carbon Risk Audit – 2022 Results **Pensions Committee** **10th March 2022**	**Classification** **PUBLIC** **Ward(s) affected** **ALL**	**Enclosures** **One** **AGENDA ITEM NO.** **4**

1. **INTRODUCTION**

1.1 This report presents the results of a carbon risk audit carried out on the Fund's equity. The audit has been carried out by TruCost to measure the Fund's carbon footprint and exposure to future CO_2 emissions, and to assess progress made against the Fund's target to reduce exposure to future CO_2 emissions by 50% by 2022. It also sets out some high level next steps for the Fund in terms of both climate change reporting and the Fund's approach to Responsible Investment more widely.

1.2 The results show that the Fund has reduced its exposure to carbon reserves by 96.9% between July 2016 and November 2021. This demonstrates significant outperformance of the Fund's original target to reduce exposure by 50% by 2022.

1.3 We are proud to have responded to this issue early and to have been one of the first LGPS funds to set and transparently monitor performance against a carbon reduction target. The target has helped highlight the areas of greatest risk within the Fund's investment strategy and helped the Fund integrate carbon risk into the strategy setting process. The changes made have delivered very significant reductions in risk.

1.4 The Fund's investment strategy has seen significant changes since 2016 and so has the range of carbon risk data available. The 'Next Steps' section of this paper sets out how the Fund might develop its approach to climate change reporting in the future. It sets out some proposed high level ambitions for the Fund in terms of carbon reduction as well as considering how the Fund might move from reporting on a single carbon exposure metric to reporting on a set of metrics to meet the requirements for TCFD (Task Force for Climate-Related Disclosures) reporting.

1.5 The proposed changes to the Fund's monitoring of carbon metrics is part of a wider planned update to the Fund's approach to Responsible Investment. The paper therefore also presents a draft Responsible Investment Policy for review by the

Committee, which focuses on setting out the Committee's priorities for Responsible Investment and strengthening the Fund's engagement approach.

2. RECOMMENDATIONS

2.1 The Pensions Committee is recommended to:

- Note the reduction in exposure to future CO_2 emissions by 96.9% since 2016, which significantly outperforms the Fund's target of a 50% reduction.
- Agree the Fund's ambition to deliver net zero emissions across its functions by 2040, ten years earlier than the target set by the Government, and in line with the Intergovernmental Panel on Climate Change's higher confidence threshold for limiting global warming to 1.5C above pre-industrial revolution average.
- Agree that the Fund should monitor carbon exposure using a set of metrics in line with recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD)
- Approve the draft Responsible Investment Policy

3. RELATED DECISIONS

- Pensions Committee - 17th February 2020 - Carbon Risk Audit
- Pensions Committee - 29th March 2017 - investment Strategy Statement
- Pensions Committee - 24th January 2017 - Investment Strategy Statement
- Pensions Committee - 19th September 2016 - Update on climate change recommendations and presentation of carbon footprinting results.
- Pensions Committee - 28th January 2016 - Future Workstreams - Climate Change

4. COMMENTS OF THE GROUP DIRECTOR OF FINANCE & CORPORATE RESOURCES

4.1 The Pensions Committee acts as Scheme Manager for the Pension Fund and is therefore responsible for the management of £1.9 billion worth of assets and for ensuring the effective and efficient running of the Pension Fund. 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 promises, which are underwritten by statute.

4.2 The Fund recognises that investment in fossil fuels and the associated exposure to potential stranded assets scenarios 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. This report provides the Committee with a greater understanding of where climate risks are concentrated within its investment portfolio, which can then be used to help mitigate those risks within its investment strategy.

4.4 The Group Director is very pleased to report the reduction in exposure to future CO_2 emissions by 96.9% since 2016, which indicates that the Fund has significantly outperformed its target of a 50% reduction by 2022. The reduction is fully compatible with the Fund 's wider investment strategy and has been achieved with no negative impact on performance; the Fund's performance has improved relative to its peer group (other local authority pension funds) over the 6 year period since the introduction of the target.

5. COMMENTS OF THE DIRECTOR OF LEGAL AND GOVERNANCE SERVICES

5.1 The Pensions Committee has delegated authority for managing all aspects of the Pension Fund including the following from the Committee's Terms of Reference:

- To formulate and publish an Investment Strategy Statement
- To set the overall strategic objectives for the Pension Fund, having taken appropriate expert advice, and develop a medium term plan to deliver the objectives.
- To determine the strategic asset allocation policy

5.2 Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 requires the Administering Authority to formulate an Investment Strategy Statement (ISS) in line with guidance published by the Secretary of State. The guidance requires the Fund to include a section on its approach to Environmental, Social and Governance (ESG) factors within its ISS.

5.3 In 2014, the Law Commission produced guidance on the fiduciary duties of investment intermediaries, which indicated that investors should have regard to ESG factors where they are financially material. In its guidance to occupational schemes, the Pensions Regulator has given a clear indicator that it believes this to be the case for climate change.

5.4 This report helps to demonstrate that the Committee is factoring climate risk into its investment strategy setting process as a material financial risk and will make clear disclosures with regards to its approach in the ISS as required by the LGPS (Management and Investment of Funds) Regulations 2016.

6. BACKGROUND TO THE REPORT

6.1 In January 2016, the Fund held its 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 that 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. The recommendations were as follows:

- 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)

- 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
- Review options for the Pension Fund's passive UK equity mandate
- 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.
- 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
- Consider options for an initial active investment of approximately 5% of the Fund in a sustainability/low carbon or clean energy fund(s)
- Review options for switching some of the existing property mandate into a low carbon property fund
- In recognition of the financial risks posed by climate change, resolve to amend the Fund's risk register to reflect this as a risk

6.2 The Fund has now completed work on all of the above recommendations. Since 2016, the Fund has:

- Included a carbon reduction policy statement within the ISS, clearly setting out the carbon reduction target
- Commissioned 3 carbon footprint reports (2016, 2019 and 2022) - these have been used to set and monitor the Fund's carbon reduction target
- Reviewed exposure to UK passive equities (one of the Fund's most significant sources of exposure to reserves) and removed this allocation from the Fund's investment strategy
- Changed the Fund's active equity managers, ensuring that the new managers consider carbon risk as an integral part of decision making. The Fund continues to engage with both its active and passive equity managers
- Stepped up involvement with the work of the Local Authority Pension Fund Forum (LAPFF), which engages collectively on behalf of local authority pension funds. Cllr Chapman, Chair of the Pensions Committee, is now a member of the LAPFF executive and attends engagement meetings on behalf of the group
- Invested 35% of the Fund in sustainable/low carbon equity funds, far above the initial commitment of 5%
- Switched £25m of the Fund's property mandate into Threadneedle's Low Carbon Workplace Fund, which is a partnership between Columbia Threadneedle Investments, the Carbon Trust and property developer Stanhope. Through the fund, the partnership acquires commercial office buildings and refurbishes them, turning them into 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

- Amended the Fund's risk register to include carbon risk/stranded assets within the Fund's Environmental, Social and Governance risks

6.3 We are very pleased by the progress made on implementing these recommendations. The Fund has gone significantly beyond the original recommendation in many cases, perhaps most notably in the case of the carbon footprinting recommendation and investment in sustainable and low carbon equity funds. .

7. BACKGROUND TO THE REPORT

7.1 The Fund undertook its first carbon risk audit in summer 2016, following the recommendation made at the January 2016 meeting to commission a carbon footprint report for the Fund. Carried out by Trucost, the audit assessed not only the carbon footprint of the Fund's equity portfolio, but also its exposure to future emissions through fossil fuel reserves.

7.2 The Fund's view is that exposure to future emissions most accurately represents the risk to the Fund from investing in fossil fuel companies. Assessing exposure to emissions from reserves in this way helps the Fund to take a view on its exposure to potentially stranded assets that may prove unusable as a result of the transition to a low carbon economy.

7.3 After careful consideration of how carbon risk could best be reduced within the investment management framework in which LGPS funds operate, and after taking proper advice, the Committee considered it appropriate to propose a quantifiable, time-bound target for a reduction in the Fund's exposure to future fossil fuel emissions. The Committee agreed that the Fund should:

- Reduce 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 and adjusted for Assets Under Management (£AUM)

7.4 The proposal represented an initial step in ensuring that the Fund is prepared for transition to a low carbon economy. It clearly set out the timeframe for decarbonisation and defined how it should be measured, making it the most ambitious carbon reduction target amongst the London LGPS funds.

7.5 As the target was to be assessed over 2 valuation cycles, the Committee had an interim audit carried out at the 3 year point to review progress against the target and assist with decision making for the 2020 investment strategy. The interim audit showed that the Fund had reduced its exposure to carbon reserves by 31.4% between July 2016 and November 2019. This placed the Fund well over halfway to its target of 50%, and also highlighted some clear areas for improvement.

7.6 The Fund made a number of investment strategy changes during 2021, with relatively few changes to the equity mandates planned for 2022. The decision was therefore made to bring forward the final assessment date for the target to 30th November 2021. This report presents the results of that final assessment, setting out the Fund's outperformance against its 50% target.

8. **SUMMARY OF PERFORMANCE AGAINST TARGET**

8.1 The audit shows that the Fund has reduced its exposure to carbon reserves by 96.9% between July 2016 and November 2021.

8.2 Trucost has analysed the carbon emissions embedded within the fossil fuel reserves that are disclosed by the underlying companies within the Fund's equity portfolio. The emissions measured are the potential future amounts of CO_2 that could be released if the fuel reserves disclosed were to be burnt. The Committee has used this metric to set its target as it gives an indication of the extent to which the Fund is exposed to assets (i.e. coal, oil and gas reserves) that may be at risk of stranding.

8.3 The results shown here are normalised by asset value; the future emissions measured for each portfolio (2016 and 2022) have been divided by the value of holdings for that portfolio. This gives a figure for emissions intensity. The figures for 2016 have been restated from previous assessments to allow for changes in Trucost's methodology since 2016. The range of carbon data available and the tools for analysing it have developed significantly since 2016, and Trucost now use a different method of apportioning emissions to companies, that takes account of bondholders as well as equity owners. It has therefore been necessary to restate the figures from 2016 to ensure a comparable dataset.

8.4 The Fund's equity portfolio as at 31st August 2016 (as used in the initial assessment) had an emissions intensity of 5,497.25 tCO_2e/VOH (tonnes of carbon dioxide divided by value of holdings), whilst the equity portfolio as at 30th November 2022 has an emissions intensity of 174.51 tCO_2e/VOH. This represents a reduction of 96.9% since 2016, well in excess of the Fund's original target.

8.5 We are extremely pleased with this result, which represents the culmination of 6 years of work. We do, however, recognise that there is more to do. The Fund set its original target 6 years ago, when its investment strategy looked very different and monitoring of carbon risk data was very much in its infancy. 6 years ago, very few funds made use of carbon monitoring data and Hackney was one of the first LGPS funds to do so.

8.6 We wish to remain at the forefront of carbon risk management and aim to do so by making use of the wider range of information now available. The Fund will therefore be aiming to move away from monitoring a single carbon risk metric and instead look to implement a range of metrics in line with the recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD).

8.7 It should be remembered that carbon risk data is complex and has certain inherent limitations. One key issue is that of disclosure - the usefulness of any metric will depend on the reliability of the data submitted at the company level. The use of a single metric for measurement of carbon risk does increase the risk that disclosure issues will limit the usefulness of data; this is one of the drivers behind the proposal to move to multiple metrics for reporting carbon risk.

8.8 We therefore recognise both that limitations remain around disclosure and that data can be used and interpreted in different ways. The Fund's approach is to use this carbon risk audit as a guide to where the most significant risks are concentrated and to use this to inform decision-making around strategy setting and risk management. The metrics disclosed can also be used to inform the Fund's engagement with its managers and investee companies, as well as potentially assisting us in improving climate-related disclosures.

9. RESPONSIBLE INVESTMENT POLICY

9.1 The Fund has made significant strategy changes over the past 6 years, driven by wider economic changes and the government's asset pooling strategy as well as increased awareness of carbon risk. Much of the reduction in the Fund's exposure to carbon risk has been achieved through changes to the investment strategy. As we move into the next phase of asset pooling, the Fund expects to make fewer major strategic changes and focus more on developing its new supplier relationships.

9.2 The expectations placed on pension funds in terms of Responsible Investment are also changing significantly; the new Stewardship Code puts much more emphasis on the ability of organisations to demonstrate robust engagement processes. Taken together, these developments suggest a shift in emphasis from addressing environmental, social and governance ESG risks through strategic change to strengthening the Fund's engagement approach and working collectively with suppliers and other funds.

9.3 This paper therefore sets out a high level Responsible Investment Policy for review by the Committee. The Policy sets out the Committee's priorities for Responsible Investment. The Committee has identified 3 priority themes on which to focus, which take into account a number of the UN's Sustainable Development Goals. The Committee's priority themes are as follows:

- Climate Action

  The Committee recognises that there is an urgent action to combat climate change and its impacts and that this will be achieved through the progressive reduction in carbon emissions in pursuit of a net zero society. The Committee has an ambition of achieving net zero in its investment portfolio by 2040 and will set progressive targets for change that seek real world emissions reductions, not just reductions in reported emissions

- Developing Clean Energy Systems

  The Committee recognises that there is a need to decarbonise the production, distribution and storage of energy. The Committee further recognises that progress can come both through technological and behavioural changes. Accordingly, the Committee will seek to allocate capital to potential solutions whilst also focusing on efforts made within investee companies to create change.

- Investing for the human condition

  The Committee recognises that climate change will affect people and there is a need to ensure that any transition to a low carbon economy is just. The Committee further recognises that issues such as human rights, diversity and gender equality are all crucial to a smoothly functioning social system. The Committee will monitor exposure to a range of social factors and engage with its investment managers where necessary to ensure that action is being taken

9.4 The Policy sets out the Committee's approach to voting and stewardship more widely, and sets out the role of the Role Investment Working Group (RIWG). The RIWG will have a membership made up of both Councillors and officers and will be responsible for setting the Fund's stewardship priorities and engaging on these with managers and other relevant stakeholders.

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Appendices
Appendix 1 - Draft Responsible Investment Policy