Title of Report	Responsible Investment - Climate Target Setting
For Consideration By	Pensions Committee
Meeting Date	30 March 2023
Classification	Public (including Exempt Appendix)
Ward(s) Affected	All
Group Director	Ian Williams, Group Director Finance & Corporate Resources

1. Introduction

1.1. This report presents the Pensions Committee with a set of recommendations for net zero interim targets. The Committee's ambition is for the Fund to achieve net zero emissions by 2040; this paper proposes 3 shorter term interim targets to help the Committee monitor progress. The proposals are recommended to the Committee by the Responsible Investment Working Group, who have had the opportunity to consider them in detail.

1.2. The proposed targets have been designed to assist the Fund in achieving net zero by 2040. They incentivise both portfolio and real world decarbonisation and are in line with emerging best practice in this field, ensuring that the Fund remains a leader amongst its Local Government peers and other institutional investors.

2. Recommendations

2.1. The Pensions Committee is recommended to:

- **Set a decarbonisation target on the fund's carbon footprint:**
    - **50% reduction in carbon footprint (scope 1&2) by 2030 compared to 2023 carbon footprint as the baseline.**
- **Adopt implied temperature rise as a forward looking metric that contributes to real world decarbonisation:**
    - **Target a 2C portfolio by 2030 with a 1.5C goal for 2040.**
- **Set a climate solutions allocation target as follows:**
    - **Allocate 10% of Fund assets to climate solutions over the next 5 years in line with the Strategic Asset Allocation (SAA) changes.**

3. Related Decisions

3.1. Pensions Committee 19 January 2023 - Climate Target Considerations

3.2. Pensions Committee 22 November 2022 - TCFD Consultation Response

3.3. Pensions Committee 15 June 2022 - Carbon Risk Audit 2022 – Full Results & Presentation (TruCost)

4. Comments of the Group Director of Finance and Corporate Resources.

4.1. The Pensions Committee acts as Scheme Manager for the Pension Fund and is therefore responsible for the management of £1.8 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 climate change represents a systemic risk that will have an impact on investment portfolios - including both transition and physical risks, but also opportunities to contribute to the transition to a net zero economy.

4.3. In considering its net zero investment strategy, the Committee will need to remain mindful of its fiduciary duties and how the various components of the proposed strategy (investment objectives, climate risk, carbon emissions and impact on the real economy) will impact its decision making.

4.4. The use of climate targets can help the Fund monitor its climate risk exposure and progress towards net zero. The targets used by the Pension Fund will differ from those of the Council given the Fund's focus on its underlying investment portfolio and hence the wider economy. This is in contrast to the Council's focus on the local area.

4.5. There are no immediate financial implications arising from this report.

5. Comments of the Director of Legal, Democratic and Electoral Services

5.1. 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.

5.2. In autumn 2022, the Department for Levelling Up, Housing and Communities (DLUHC) released a consultation on the introduction of TCFD (Taskforce on Climate-related Financial Disclosures) reporting for the LGPS. The consultation sets out proposed TCFD regulations to apply to LGPS Administering Authorities (AAs) from 2023/24. It is anticipated that the regulations will require AAs to produce annual TCFD reports from December 2024 and that these must include certain metrics and targets.

5.3. This report helps to demonstrate that the Committee is showing due regard to climate change as a financially material ESG factor. It also demonstrates that the Committee is proactively adopting suitable climate metrics and targets well in advance of the anticipated statutory requirement to use these for TCFD reporting purposes from December 2024.

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

6. <u>Background to the report</u>

6.1. This report presents the Pensions Committee with a set of recommendations for setting interim climate targets as part of its net zero strategy. The Committee's ambition is for the Fund to achieve net zero emissions by 2040; this paper proposes 3 shorter term interim targets to help the Committee monitor progress and more fully understand its exposure to climate related risks and opportunities.

6.2. The Fund recognises that climate change represents a systemic risk that will have an impact on investment portfolios. It brings significant risks, including both transition and physical risks, but also opportunities to contribute to the transition to a net zero economy. The inevitable impact of climate change on investment portfolios means that it is vital to integrate it into investment decision making.

6.3. Taskforce on Climate-related Financial Disclosures (TCFD) reporting is the most common framework for embedding climate risks into investment decision making, and the Fund is likely to be required to make use of it from 2023/24. However, the TCFD is designed for evaluating how climate risks and opportunities impact an asset owner's investment strategy, but not the impact investment decisions might have on climate change and hence the real world economy.

6.4. Investors can respond to the objective of reaching net zero by focusing on portfolio decarbonisation, or by targeting real economy decarbonisation. Portfolio decarbonisation is an approach that involves selling higher emitting assets in favour of lower emitting ones. It can help investors to manage their own exposure to carbon risks but does not influence what is occurring within the real economy, and therefore cannot address any of the root causes of the systemic risk posed to investors.

6.5. Targeting real economy decarbonisation means investing in a way that targets a real-world impact and is aligned with what is occurring in the real economy. Some investors incorporate such real-world impacts into their investment process. Investing in a way that is aligned to the global net zero transition, could increase a portfolio's emissions in the short term, but should lead to portfolio decarbonisation over the longer term.

6.6. The Hackney Fund was an extremely early adopter of carbon targets, having previously set a target in 2016 to reduce its exposure to fossil fuel reserves by 50% over 6 years. This metric provides an indication of the Fund's exposure to companies that own carbon reserves (oil, coal and natural gas reserves that have not yet been extracted). It also indicates the Fund's exposure to future emissions when the fossil fuel reserves are extracted and used. This metric was chosen as it aims to focus stranded asset risk, a key financial risk to the Fund from owning fossil fuel companies

6.7. By 2022, the Fund had reduced its exposure to carbon reserves by 96.9%, considerably outperforming its target. This was achieved through significant portfolio decarbonisation, as the Fund disinvested from mandates with high exposure to carbon reserves in favour of more sustainable investment opportunities. The target focused on the Fund's equity mandates and the Fund therefore now has a much lower exposure to fossil fuels in these mandates and a lower carbon footprint overall.

6.8. Whilst the Fund has therefore made significant progress already, the previous target did not capture the Committee's wish to make a positive contribution to the transition to a low carbon economy, through investments in renewable infrastructure mandates and other asset classes such as low carbon property. It is therefore intended that the new targets set should focus on real economy decarbonisation and the positive climate impact of the Fund's investments, as well as covering a wider range of the Fund's assets.

7. Proposed Targets

7.1. Climate target setting for investors has evolved rapidly since the Fund set its initial target in 2016. Industry best practice is now emerging, particularly as corporate pension schemes now have a statutory obligation to produce TCFD reporting.

7.2. Leading investors are now setting a suite of climate targets to achieve climate objectives and manage exposure to risk. In line with emerging best practice and to help ensure the Fund remains a leader in this field, this paper recommends that the Committee adopts 3 net zero interim targets covering the following areas:

- Emissions reduction
- Increased alignment of assets
- Allocation to climate solutions

7.3. The emissions reduction target proposed is for the Fund to make a 50% reduction in its carbon footprint (scopes 1&2) by 2030 compared to 2023 carbon footprint as the baseline. As discussed in Section 6, the Fund's previous decarbonisation target used exposure to reserves as the chosen metric. Switching to carbon footprint will widen the scope of the target, moving away from a narrow focus on companies that own fossil fuel reserves and towards emissions across the whole portfolio. The target is a highly ambitious one, given that the Fund has already made significant progress on decarbonising its equity portfolio.

7.4. Alignment is a measure of the extent to which a company's activity now and in the future is consistent with achieving global temperature goals. There are various types of measurement, and numerous assessment providers. The three broad categories used are as follows:

- Binary Target Measurement - Measures the alignment of a portfolio with a given climate outcome, based on the percentage of investments in that portfolio with declared Net Zero or Paris-aligned targets.
- Benchmark Divergence - Assesses portfolio alignment by comparing the performance of investments in the portfolio against one or more benchmarks based on climate scenarios.
- Implied Temperature Rise - Translates degree of alignment into impact in the form of a temperature score that can be compared against the temperature goals of the Paris Agreement.

7.5. The first two types of metrics; binary target measurement, and benchmark divergence models can be used when reviewing individual securities, and challenge engagement activity undertaken by fund managers. The Implied Temperature Rise metric, however, can be aggregated across the whole portfolio to provide an overall temperature score that can be compared against the goals of the Paris agreement.

7.6. Both the binary target and benchmark divergence models rely on company disclosure and require manual assessment of companies via third party initiatives. This results in very low coverage across the investable universe, making them less suitable for target setting across the whole of the Fund's portfolio.

7.7. The alignment metric proposed for the Fund is the Implied Temperature RIse (ITR) metric. This is a modelled metric, and therefore covers the majority of the Fund's assets. Although complex to calculate, it is highly intuitive and easy to communicate to stakeholders. It is also, unlike the emissions reduction metrics, a forward-looking metric which helps to assess the portfolio's future trajectory.

7.8. It is therefore recommended that the Committee adopts implied temperature rise as a forward looking metric and targets a 2C portfolio by 2030 with a 1.5C goal for 2040. This is once again an ambitious target; temperature projections for 2030 indicate a 2.4C warming scenario, whilst the most optimistic scenario for 2050 is 1.8C.

7.9. The proposed 'allocation to climate solutions' target is intended to assist the Fund in increasing its exposure to assets that can provide a positive contribution to the transition to a net zero economy. There is no universally accepted definition of the term ‘climate solutions’; however, one common classification groups activities into either ‘transition’ or ‘enabling’ activities.

7.10. Transition activities are economic activities with substantial contributions to emissions reductions relating to a company’s performance, as required by a 1.5℃ pathway, or to climate adaptation.. Examples include the production of electricity from renewables or the construction of new buildings with best-in-class energy performance.

7.11. Enabling activities are economic activities that make a substantial contribution to the transition to net zero by enabling emissions reductions in the wider economy as well as reducing emissions of a company’s sold products and services.

7.12. Based on these high-level definitions, the Fund’s current allocation to climate solutions is 1.5%. The Investment Strategy Review paper included in this meeting’s agenda pack sets out 2 proposed strategic asset allocation changes which, if implemented, would bring the Fund’s allocation to climate solutions up to 10%.

7.13. The suggested target is therefore to allocate 10% of the Fund’s assets to climate solutions over the next 5 years. The target could then be reviewed in 5 years time to determine if future increases are appropriate.

8. Conclusions and Next Steps

8.1. Should these targets be approved, the next step will be implementation. The climate targets set will inform future investment decisions, including:

- Strategic Asset Allocation changes
- Fund and (where necessary) manager selection
- Portfolio construction
- Engagement strategy

8.2. The Fund can consider a number of different approaches when considering how to achieve its climate targets. These include:

- Strategic changes - This would involve selling certain mandates/asset classes and investing in mandates/asset classes that have better climate characteristics. The Investment Strategy Review paper included in this meeting’s agenda pack sets out 2 proposed strategic asset allocation changes which, if implemented, would bring the Fund’s allocation to climate solutions up to 10%.
- Switching mandates - Bring the Scheme’s assets to closer alignment with the Committee’s net zero objectives by making mandate switches out of high-carbon to lower-carbon. This was the approach taken to meet the Fund’s previous target

- Within mandate changes - This involves selling those assets within a mandate that are not aligned to the Committee's long-term objectives. This is generally only possible in segregated mandates and is difficult in pooled mandates which make up most of the Fund's investments.
- Active engagement - This involves identifying areas that are not in alignment with the Committee's net zero objectives and engaging with the relevant managers and underlying companies to improve the identified companies' climate profiles.

8.3. The proposed targets are intended to help drive a focus on decarbonisation in the real economy as well as within the portfolio. They also take account of developments in the field of climate reporting to help ensure that the Fund is setting targets that are highly ambitious but also credible.

8.4. It should be remembered that the Fund's approach to net zero strategy setting will differ from that of the Council. The Council's Climate Action Plan is focused on taking action to achieve net zero within the local area. In contrast, the Pension Fund needs to focus on its underlying investment portfolio.

8.5. To achieve its primary purpose of paying pension benefits as they fall due, the Fund needs to maintain a well diversified portfolio of investments. This will involve maintaining exposure across different sectors of the economy, some of which will decarbonise faster than others. Some high carbon sectors will also be crucial to decarbonisation in other sectors of the economy; for example, the construction industry is vital to the development of renewables and decarbonisation of real estate.

8.6. This complexity exposes the Fund to constraints on its pace of change which are not experienced by the Council. The proposed interim targets for the Fund are highly ambitious and require change faster than that projected to occur in the wider economy. They will require the Fund to invest positively in climate solutions and engage to drive change within the wider economy in addition to reducing negative impacts via emissions reduction.

Appendices

Appendix 1 (EXEMPT) - Climate Target Setting
By Virtue of Paragraph(s) 3 Part 1 of schedule 12A of the Local Government Act 1972 this report and/or appendix 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.

Background documents
None

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