worcestershire countycouncil

AGENDA ITEM 6

PENSIONS COMMITTEE
16 MARCH 2021

OUTCOME OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) AUDIT, SUSTAINABLE DEVELOPMENT GOALS MAPPING AND CLIMATE RISK REVIEW

Recommendation

1. **The Chief Financial Officer recommends that:**

   a) **Worcestershire Pension Fund (the Fund) ESG Audit and Sustainable Development Goals (SDGs) Mapping Exercise project report from Minerva be noted and approved (Appendix 1)**

   b) **The 'Task Force on Climate related Financial Disclosures' (TCFD) Report be commented on and approved. (Appendix 2)**

   c) **The outcome of the ESG audit, SDG Mapping and Climate Risk review be noted, and the recommendations set out at paragraphs 20 to 24 of this report be approved, namely:**

      - **Monitoring of Fund Managers**
      - **New guidelines for future Fund Manager selection**
      - **Working with LGPS Central**
      - **Considerations for the future investment strategy**
      - **SDG & Climate Reporting, and metrics.**

Background

2. This report aims to bring together the conclusions from the ESG Audit & SDG Mapping project for the Fund by Minerva and LGPSC Central initial Fund specific Climate Risk Report. However, it is worth re-iterating what we mean by Responsible Investment.

Responsible Investment

3. Responsible investment is an approach to investment that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long term returns.

4. It has relevance both during the selection of an investment and after an investment decision has been made, through on-going stewardship activity which covers considered voting and engagement with investee companies. Responsible investment is a core part of the Fund's fiduciary duty. It is distinct from 'ethical investment', which is an approach to selecting investments on the basis of ethical beliefs (beliefs about what is morally right and wrong). ESG Factors include:-

<u>The Funds Responsible Investment journey so far</u>

5. The Funds journey so far has been as follows, which has resulted in this report and recommendations for the Committee to consider:

a) Training on Responsible Investment, Sustainable / Impact / Ethical Investment, and the spectrum of capital 31 January 2020;
b) Agreement by the Pensions Committee in March 2020 to conduct an ESG Audit as part of its agreed Strategic Asset allocation plan;
c) Workshop to discuss and debate the Fund's investment beliefs for a sustainable approach to investing. This included an introduction to the 17 United Nations SDG's and members agreed to prioritise the following SDGs that they considered are likely to have the biggest investment impact:

- *SDG 9. Industry, Innovation & Infrastructure (covers off 11 sustainable cities)*
- *SDG 7. Clean Energy (covers off 6 clean water and sanitation)*
- *SDG 8. Decent Work & Economic Growth*
- *SDG 13. Climate Action*

d) Member led specific ESG Audit & SDG Mapping working group agreed at June Pensions Committee;
e) Appointment of Minerva 29 September 2020 to conduct an ESG Audit & SDG Mapping project for the Fund. To specifically examine the existing Investment Portfolio holdings of the Fund and their relationship (positive/ negative) to the 17 Sustainable Development Goals, specifically highlighting the SDGs detailed above in (c) and identify the risks and opportunities associated with the analysis;
f) Pool engagement – LGPSC Central initial Fund specific Climate Risk Report discussed at the working group in October and November 2020 with LGPSC Responsible Investment and Engagement Team;
g) Minerva report on baseline assessment of mapping the Fund's portfolio to the UN SDG's reported to the ESG Audit working group 18 December 2020 and all member workshop on the 5 January 2021;
h) Review and next steps for a sustainable approach to investing workshop with all members on the 5 February 2021; and

i) Agreement by the ESG Audit working group to the recommendations from the 5 February workshop and the final report from Minerva on the Funds ESG and SDG mapping for submission to this Committee.

Environment Social and Governance Audit & SDG Mapping – Minerva Report

6. Minerva were appointed to conduct an Environment Social and Governance (ESG) audit of the Fund and be able to map **all** the Funds' investments to the United Nations Sustainable Development Goals (SDGs). This was to establish a baseline for the Fund as to where we are and help formulate future strategic actions required for the Fund's investment approach.

7. This involved examining the existing Investment Portfolio holdings of Worcestershire Pension Fund and their relationship (positive/ negative) to the 17 United Nations SDGs, specifically highlighting the SDGs detailed below and identify the risks and opportunities associated with the analysis.

- **SDG 9. Industry, Innovation & Infrastructure**
- **SDG 7. Affordable & Clean Energy**
- **SDG 8. Decent Work & Economic Growth**
- **SDG 13. Climate Action**

8. Minerva have worked closely with the ESG Working group and provided a detailed presentation on the key aspects and findings of their ESG Audit and SDG Mapping report to the member workshop on the 5 January 2021 and also attended and supported the Review and next steps for a sustainable approach to investing workshop on the 5 February. Their final report is attached as Appendix A.

9. The key outcomes are:

a) The fund is already aligned to its SDG goals to a reasonable level;
b) Within the private assets, 2 Fund managers portfolios are 'Very Strongly Contributing' in SDG terms and 1 Fund Managers portfolio is 'Detracting', given its significant exposure to the Oil and Gas sector;
c) Comparing the Fund's listed assets against the SDG2000, there is an overlap of 50.4%. (The Fund's listed assets represent 70% of our portfolio); and
d) Although that overlap was unintentional rather than by design.

SDG 2000

Minerva used the World Benchmarking Alliance (WBA) SDG2000 to measure the alignment between the Fund's investments and the SDGs. The WBA SDG 2000 measures and ranks 2000 of the world's most influential companies in respect of SDGs. These are seen as global companies that are likely to have the greatest potential to help deliver the SDGs

10. Minerva also highlighted some potential actions to consider as part of the next steps
- tackling the 'weaker' areas in the Fund's investments by having a **proactive identification and engagement** approach with:
  i. the **lowest-rated Fund SDG2000 holdings**, and
  ii. those **other Fund investments** deemed as being **SDG-detracting**.
- creating a **more rigorous approach** towards future manager **appointments** / real asset **investments** and **re-ups**.

- to **review the Fund's existing ISS** to assess whether changes are needed to 'Investment Beliefs', and to incorporate appropriate SDG references, including any specific SDGs on which Members wish to focus.
- look at including the **potential to disinvest** where appropriate (as suggested in project report); It should be noted that this is not currently the Fund's policy but could be considered in the future if a particular manager or company was not making any attempt to comply with our Fund's stated policies,
- future reporting requirements, including being in line with **TCFD** recommendations; and
- explore the potential for **additional allocations** to sustainable and/or low carbon equities

LGPSC Climate Risk Report

11. The Committee has been kept updated that LGPS Central are providing and continuing to develop a Climate Risk Monitoring Service. This has four optional deliverables

- Assistance drawing up a climate change framework and strategy
- Per fund an annual climate change risk report tailored to individual funds requirements comprising
    - Climate scenario analysis, fund wide, all asset classes
    - Carbon metrics scorecard (carbon footprint, stranded asset analysis, etc.
    - Annual climate stewardship plan
- Per fund annual training of Pensions Committee
- Task Force for Climate-related Financial Disclosures (TCFD) report for public disclosure with our annual report

12. LGPSC produced a Climate Risk report in September for the Fund which was discussed in detail at the ESG Audit WG in October and November 2020. Our independent asset advisor detailed his synopsis of the report

LGPSC Climate Risk Report - Synopsis of Funds Independent Advisor

13. The Report is relatively limited in scope, reviewing the equity portfolios (active and passive) only. It is focused purely on Climate Risk, specifically the Fund's carbon footprint. As such it forms a useful part of the wider review of the Fund's ESG strategy, but should not be viewed in isolation when considering the options for changes in the Investment Strategy Statement. The Report should be viewed as complementary to the ESG review being undertaken by Minerva, rather than viewed in isolation.

14. The Report is designed to provide guidance for investing in a sustainable way, including some "what if" scenarios relating to the potential impacts of various degrees of global warming. Clearly this requires some assumptions to be made, these have to be reasonable in their basis, but ultimately only time will tell if they are correct.

15. Before receiving this report, the Fund had some of our own assumptions about how "healthy" WPF is in terms of how our investments impact on the climate, bearing in mind the high exposure to index tracking funds which will include the good, the bad and the ugly in their composition. The report contained a lot of good news in this respect, in fact we are much healthier than we had assumed, including a lower exposure to fossil fuels than the benchmark position.

16. Climate related risk is very real and can impact the Fund both negatively and positively, depending on our approach to managing that risk. There is sector and stock specific risk in being invested in those areas that include fossil fuels, as they decline in usage, whereas investing in new more environmentally friendly areas, such as renewable energy, can enhance our investment returns. The warmer the planet becomes, the risks increase much further, which at the simplest levels include substantial flooding of low lying areas globally with all the negative implications that flow from that.

17. The key highlights / points of the report are:

- The Total Equities portfolio has a portfolio carbon footprint that is 23.75% lower than the benchmark, with all underlying active strategies significantly lower than their benchmark

- The Total Equities portfolio has less exposure to fossil fuels than the benchmark

- Climate Scenario Analysis suggests a 2°C outcome is the best from a return perspective.

- A hypothetical "Sustainable Asset Allocation" – which adjusts the Strategic Asset Allocation by
  (i) incorporating low carbon and sustainable equities and
  (ii) increasing allocation to sustainable infrastructure – would, according to the model used, perform better than the Strategic Asset Allocation in a 2°C scenario

  (It should be noted that it was our hypothetical suggestion as we were given 2 options, 1 being our existing asset allocation and the other a hypothetical option of our choice)

- The Fund already shows good practice with regard to responsible investment, including Quarterly Stewardship updates and signature to the UK Stewardship Code.

18. Although there are elements in the report that are general in nature and not specific to WPF, the content is still relevant and in context to the subject matter. Guidance to the LGPS is increasingly prescriptive in terms of requiring individual Funds to take climate risk into account in the management of investments. LGPS Central have highlighted some good recommendations for consideration in respect of governance and reporting (see below). Most LGPS Funds are moving in this same direction, particularly on the reporting front, such as against the TCFD.

- **Governance:** spend time discussing progress on climate strategy and maintain training
- **Policies:** develop a climate strategy, report against 2020 Stewardship Code, include climate risk in the risk register
- **Reporting:** include information in annual report
- **Asset allocation:** consider additional allocations to sustainable investments
- **Policy engagement:** public support for Paris Alignment
- **Manager monitoring:** dialogue and engagement on climate action
- **Company stewardship:** engage and report on progress

- **Metrics:** measure metrics annually
- **Methodology:** support (via LGPSC) development of methodology to verify alignment to Paris agreement.

Overall Conclusion

19. The Fund has completed a robust ESG Audit, SDG Mapping and Climate Risk review of its portfolio and on the whole the outcomes have been positive. The key points and suggested recommendations from both the Minerva and LGPSC reports have been considered in detail over the past 4 to 5 months resulting in a number of workshops to debate and discuss these further. The suggested way forward for the Fund and next steps has culminated in a number of recommendations which are seeking Committee approval. These can be summarised in the following sections:

Monitoring of Fund managers

20. The following options proposed to be agreed are:

- Ongoing engagement, dialogue, and challenge with managers.
    - E.g. challenge on holdings (particularly the top 10 to 20 in terms of value) that detract from the Funds SDGs and carbon reduction – Explore using LGPSC Fund manager monitoring template as a method to do this.
    - Prioritise the most material / strategic exposure for dialogue on climate risk.
- Ask managers to report on the portfolio's alignment to the Funds SDG goals (detailed below) in future and Carbon Risk metrics.
    - *SDG 9. Industry, Innovation & Infrastructure*
    - *SDG 7. Affordable and Clean Energy*
    - *SDG 8. Decent Work & Economic Growth*
    - *SDG 13. Climate Action*
    - *SDG 3 Good Health & Wellbeing (added following workshop on the 5th February)*

- Ask managers to present their TCFD report
- See evidence of a strong investment thesis where the Fund may have concerns.
- Consider impact "terms of reference" against which the Fund will judge them in future – what does success look like?
- Other engagement – Consider divestment as a last resort if evidence of improvement not forthcoming and on the grounds of unaddressed financial risk and build into the Fund's Investment Strategy Statement (ISS).

New guidelines for future Fund Manager selection

21. The following options proposed to be agreed are:
- Introduce impact criteria into the Fund's manager selection decisions
    - E.g. Does the manager report against the SDGs, or CO2 emissions?
    - Do they have a clear investment thesis around climate change, decent work, and innovation?
- Is the manager TCFD compliant.
- Consider allocating some of the scoring weights in any procurement specifically to ESG (e.g. 70% of the score based on investment, 20% on price and 10% on ESG)

Working with LGPS Central

22. The following options proposed to be agreed are:
    - Ask LGPS Central to report on both impact and financial deliverability on a regular basis
    - Challenge and monitor their TCFD reporting.
    - Ask for evidence of further improvements being made over time
    - Maintain a dialogue over the types of investments/funds you wish to see in the Pool
    - Collaborate with other member funds and Pools to share ideas
    - Review LGPSC's stewardship plan (four themes: climate change, single-use plastic, technology & disruptive industries, and tax transparency) to assess if this is still in line with the Funds priorities.
    - Identify the top 10 or 20 holdings in value terms for further dialogue and challenge that are detracting from the Funds SDG goals and carbon reduction

Future investment strategy

23. It was emphasised at the start of this discussion that the *Aim: to deliver strong risk-adjusted returns in accordance with the committee's fiduciary responsibilities*. The following options were discussed and agreed:

- To explore further the examples of potential investments that were presented regarding the passive LGPSC All World equity Climate Multi Factor Fund and the five active sustainable equity funds on the West Midlands Framework
- To also take on board the existing offering of sustainable active equities that were being developed by LGPSC as an alternative to the West Midlands Framework
- To take these suggested examples to the next Investment Sub Committee for further consideration and debate.

SDG & Climate Reporting and metrics

24. The following options proposed to be agreed are:
    - To have an overarching climate statement to include in the Investment Strategy Statement (ISS).
    - Put a statement or summary of the Climate Risk report in a manner consistent with the TCFD Recommendations into the Fund's annual report.
    - Have a "best endeavours" type statement with a view to consider setting goals / targets at next year's ESG Fund review.
        - E.g. reduction of carbon footprint
        - measurement against the key SDG's,
        - To have a % of assets invested in low carbon and sustainable investments
    - Repeat carbon Metrics analysis annually
    - Repeat Climate Scenario Analysis every 2 to 3 years
    - Report annually progress on climate risk using the TCFD Framework
    - Map the Fund's portfolio to the UN SDG's every 2 to 3 years
    -

Task Force on Climate related Financial Disclosures' (TCFD)

25. The Taskforce on Climate-related Financial Disclosures (TCFD) was commissioned in 2015 by Mark Carney in his remit as Chair of the Financial Stability Board. In 2017 the TCFD released its recommendations for improved transparency by companies, asset managers, asset owners, banks, and insurance companies with respect to how climate-related risks and opportunities are being managed. Official supporters of the TCFD total 930 organisations representing a market capitalisation of over $11 trillion. Disclosure that aligns with the TCFD recommendations currently represents best practice.

26. LGPSC provided the fund with a draft TCFD report and this has been updated to include the outcomes of the work provided by Minerva and is attached to this report as Appendix 2.

SDG 3 (Health and Wellbeing)

27. At the time of the initial Committee discussions on carrying out the ESG Audit & SDG Mapping exercise (at the end of 2019 and the beginning of 2020), the full impact of Covid-19 was not known. In the intervening period, it has become clear that Covid-19 has had far reaching consequences – both human and financial – for the world. Whilst some of the Fund's underlying investments have done well in the Covid-19 environment (such as digital infrastructure and remote working service providers), others have not (such as airlines and the hospitality sector).

28. With Covid-19 vaccines now slowly beginning to be rolled out, the future is starting to look somewhat brighter – although there are no doubt many challenges lying ahead before the world is back to normal, if indeed it will ever be the same kind of 'normal' again.

29. Working with Pensions for Purpose, the Committee previously identified 4 SDGs (detailed in paragraph 5c above) that were of particular importance to them, and for which specific attention was to be paid in this exercise.

30. However, during the Workshop presentation of 5th January 2021, a question was asked as to whether the Committee might want to reflect on the impact of Covid-19, and to reconsider its previously prioritised SDGs, as SDG 3: Good Health & Wellbeing may now seem to be of increased importance. This was discussed at the workshop of the 5th February 2021 and members felt that this should be now prioritised with the 4 already agreed

Future of the ESG Audit working group and ESG Fund wide annual review

31. At the ESG WG meeting of the 5 February 2021, It was felt that the working group had now served its main purpose and that a revised working group to focus on tracking the recommendations to Pensions Committee should be formed and consideration for this after the elections.

32. It was also at considered by the working group to potentially use the January Pensions Committee as a focussed ESG annual review session and invite relevant managers in for debate and discussion.

Recent Press on the topic of Divestment

33. On 23 February 2021, Friends of the Earth ('FoTE') released a report entitled *'UK Divest: Divesting to protect our pensions and the planet – an analysis of local government investments in coal, oil and gas'.* The report represented FoTE's assessment of the investments made by LGPS Funds in coal, oil, and gas. The stated purposes of this report was to provoke conversations, inform local decision-makers, and to further the cause of divestment as a credible and necessary action in relation to carbon-intensive investments in LGPS Funds.

34. As can be seen by the work undertaken by the Pensions Committee detailed in this report, Worcestershire already recognises the fundamental importance of climate issues

in relation to the Fund's investment strategy, and has discussed the topic of divestment as part of the recent ESG Audit and SDG Mapping Exercise.

35. In Section 20 of this report, the Committee is being asked to approve the consideration of divestment from any investment as being part of the engagement process options available to the Fund and its managers, on the grounds of unaddressed financial risk and on the grounds of a particular manager or company not making any attempt to comply with our Fund's stated policies. This does not just relate to coal, oil, and gas companies, but can be considered as a last resort for all investments, if the evidence of investee companies' approaches to addressing specific ESG risks is not forthcoming or deemed suitably robust.

36. To be clear, the Committee is not being asked to approve divestment as a desired outcome, but to recognize that there may be instances where no other option remains to the Fund in the context of unacceptable unaddressed ESG risks. In the event of such circumstances, it seems prudent to have divestment as an option in the engagement toolbox available to the Fund and its managers.

37. In broader terms, changes to the LGPS Investment Regulations in relation to further clarification on ESG investment matters are expected in the future. In the run-up to COP26 this November, the UK is playing a leading role on the world stage to promote the long-term sustainable transition to a low carbon economy, and the UK's local authorities are making an ongoing and growing contribution to these significant changes through responsible investment strategies which protect pensions and the planet.

Contact Points

Specific Contact Points for this report
Rob Wilson
Pensions Investment, Treasury Management & Capital strategy manager
Tel: 01905 846908
Email: RWilson2@worcestershire.gov.uk

Supporting Information

- TCFD Report (Appendix 1)
- Minerva Final ESG Audit & SDG Mapping report (Appendix 2)

Background Papers

In the opinion of the proper officer (in this case the Chief Financial Officer) there are no background papers relating to the subject matter of this report.