South Tyneside Council

# Local Pension Board

Date: 30th March 2023

# Climate Change and Carbon Metrics

(for information and discussion)

Report of the Head of Pensions

**Purpose of Report**

1. This report has as an attachment, a report to Pensions Committee on 9th March 2023. The report provides an update on progress against climate related actions in 2022/23 Service Plan including defining appropriate carbon metrics and the production of the Fund's first TCFD Report. It also shows the latest position on the carbon metrics information provided by the investment managers.

2. The report has been shared with the Board to ensure it is also kept up to date on this high-profile issue.

**Recommendation**

3. The Local Pension Board is recommended to note the progress made on Climate Change actions in the Service Plan.

Contact Officer: Ian Bainbridge, Head of Pensions – Tel. 424 4112

South Tyneside Council

# Pensions Committee

Date: 9th March 2023

# Climate Change and Carbon Metrics

(for information and discussion)

Report of the Head of Pensions

**Purpose of Report**

4. This report reminds the Committee of the Fund's carbon reduction targets and approach to managing climate change risks and opportunities.

5. The report provides an update on the progress against the climate related actions agreed in the 2022/23 Service Plan.

6. This report highlights those portfolios which have the largest impact on the carbon footprint and provides the latest information on how each portfolio compares against its relevant benchmark portfolio and how this has moved since the previous quarter.

7. The Committee is recommended to note this report.

Contact Officer: Ian Bainbridge, Head of Pensions – Tel. 424 4112

## Background

8. The Fund has had a focus on climate change over the past two years. This led to the agreement of the Climate Change Policy, a Net Zero Carbon target and a range of interim carbon reduction targets at the Pensions Committee meeting in November 2021.

9. A summary of the agreed targets and commitments, are:

    - Annual review of the Climate Change Policy
    - A net zero carbon target for the Investment Portfolio of 2050, or sooner
    - A net zero carbon target for the administrative functions of the Fund of 2030
    - A reduction in carbon emissions of 30% to 35% by 2025
    - A reduction in carbon emissions of 50% to 60% by 2030
    - To undertake a carbon footprint on the Fund each year
    - To undertake a formal review of the targets every three years

10. This report summarises the progress against the Service Plan objectives in relation to climate change and gives an update on the carbon exposures across the Fund's investments.

## Service Plan 2022/23 to 2024/25

11. The Fund approved a Service Plan at its meeting in February 2022 for 2022/23 to 2024/25. This covered a number of actions in relation to managing climate change risk. These actions will help deliver the targets and commitments noted above.

12. A summary of these actions is noted below:

- To undertake an annual review of the Climate Change Policy
- To develop a roadmap of actions in order to deliver against the targets in the Climate Change Policy
- Undertake an annual carbon footprint analysis
- Agree a range of carbon metrics to help monitor carbon exposures

- Assessing the role of private markets in managing climate risk
- Implications of an exclusion policy if engagement is not working
- Actively engage with Managers to ensure that they are appropriately addressing the climate change related risks, opportunities and threats
- Prepare for the implementation of reporting requirements for the Taskforce on Climate Related Financial Disclosures (TCFD).

13. This report updates the Committee with the progress against each of these actions.

14. A Service Plan for 2023/24 to 2025/26 was recently approved at Pensions Committee in January 2023, which included a new range of actions. However, this report is focussed on the actions agreed for 2022/23. Actions for future years will be picked up at the Pensions Committee meetings in 2023/24.

**Review of Climate Change Policy and Net Zero Roadmap**

15. At the Committee meeting in November 2021 when the Committee approved the new Climate Change Policy it also agreed to review progress against the Policy each year and to formally review the Policy every three years. This review formed part of the annual review of the Corporate Governance and Responsible Investment Policy and consequently a new and updated Climate Change Policy was approved by the Committee at its meeting in November 2022.

16. The Roadmap to achieve the Fund's Net Zero targets set out in the Climate Change Policy was also presented to the Committee and approved at the meeting in November 2022. This set out a range of actions that need to be taken in order to deliver the Fund's medium and long term targets on Carbon reductions.

**Undertake an annual carbon footprint analysis**

17. The Fund's first carbon footprint exercise was undertaken in 2021 and used 2019 as a base year. A high-level carbon footprint was also established back to 2010. The analysis shows that the carbon footprint of the Fund had fallen by 15% from 2019 to 2021 and by 29% from 2010 to 2021.

18. Hymans Robertson has undertaken an updated Carbon Footprint as at 31st March 2022. This was included in papers for the Committee meeting in November 2022. It showed that the carbon footprint had now fallen by

21% from 2019 to 2022 and the Fund was 14% below the benchmark level.

19. Data quality and coverage have improved significantly from 2021 but remain an issue in producing reliable metrics for the Fund. Work is ongoing with the Fund's Investment Managers and 2022 will be used as the base year to measure improvements.

20. Hymans Robertson presented the Fund's carbon footprint analysis to the Pensions Committee and the Local Pension Board at the training in early March 2023.

**Agree a range of Carbon Metrics to help monitor carbon exposures**

21. There are a wide range of metrics that could be used as targets to assist in the longer-term carbon reduction targets. Consideration has been given to which targets should be adopted by the Fund. In November 2022 the Committee agreed to the following metrics which were included in the Climate Change Policy and the TCFD Report.

    - Greenhouse Gas Emissions (GHG), expressed in absolute terms (tCO2e) and normalised by invested capital (tCO2/capital invested)
    - Weighted average carbon intensity (WACI), tCO2e/$m sales
    - Weighted average % of green revenues
    - Percentage of assets under management with fossil fuel reserves, subject to a materiality threshold
    - Percentage of assets under management with thermal coal reserves, subject to a materiality threshold
    - Transition pathway alignment, for material emissions sectors
    - Data quality, percentage of assets under management covered by metrics actually reported and independently validated, rather than by estimates
    - Percentage of assets under management of companies in material emissions sectors subject to meaningful engagement.

22. These metrics have been developed from discussions between the Officers, Hymans and Border to Coast. The Fund is confident its approach and targets are consistent with those produced by Border to Coast.

## Assess the role of private markets in managing climate risk

23. This action is ongoing and was also included in the service plan for last year. Ongoing dialogue is taking place with the Fund's private market managers.

24. It is acknowledged that information on climate change risks and carbon exposures in private markets is extremely limited, but it is improving.

25. Border to Coast has commissioned Albourne partners to review the ESG and climate change credentials of their current and potential private market managers. The outcome of this work is still awaited.

26. The Local Authority Pension Fund Forum (LAPFF) has agreed to look at this area as part of the 2022/23 workplan. They have advised us of a report which has been produced by Ceres (of which LAPFF is a member) called 'The Changing Climate for Private Equity'. CERES are a non-profit organisation who promote sustainability solutions. The report provides a good overview and assessment of the role of private markets in managing climate risk.

27. Ceres consider that while many businesses and financial system actors have committed to reach net zero by 2050 or sooner, private equity has been slower to act. The report includes examples of 'leading practices' from interviews both with pension funds and private equity firms, the latter spread across Europe, the UK and the US. A copy of the report is available on the LAPFF website.

## Implications of an exclusion policy if engagement is not working

28. This action is ongoing and will be kept under review with the Fund's Investment managers.

29. The Fund has an investment belief that "Well run companies will produce superior returns for shareholders over the longer term. There should be a focus on governance and engagement over disposal".

30. This does not mean that stocks will be held onto where material concerns have been identified around environmental, social and governance (ESG) and climate change risks or any risk for that matter. Should an ESG or climate change risk be identified that is material enough to require the stock to be sold, this will be supported by the Fund.

31. However, decisions to sell or divest should be undertaken on an individual stock level where:

- the Company is not addressing issues raised and we as the investor are not compensated for the risk

- we as the investor could reinvest capital elsewhere with the same returns and less risk.

32. If a stock is sold for the reasons noted above (or for any reason) there should be an ongoing assessment to see if the circumstances change.

33. Legal and General, the passive manager has a "Climate Change Pledge". This has led Legal and General, in certain products, to divest from thirteen companies. These exclusions apply to the Future World series of funds in which we invest. In other products, where divestment is not an option (e.g. traditional market capitalisation passive), Legal and General will seek to drive change through engagement and voting against appropriate resolutions at the company AGMs.

**Actively engage with managers to ensure that they are appropriately addressing the climate change related risks, opportunities and threats**

34. The Fund engages with the companies in which it invests through Border to Coast, the other investment managers and industry bodies such as the LAPFF.

35. At the same time, it is important that the Fund engages with its investment managers to ensure they are aware of the key issues and concerns of the Fund, so they can build this into their engagement with companies. ESG and climate change risks are covered in all quarterly meetings with the investment managers.

36. In 2021 the Fund has sent out a Questionnaire to the Funds investment managers to get a better understanding of their approach the managers adopt. This proved helpful in understanding the approach taken by each manager.

37. Border to Coast, has published a revised Responsible Investment Strategy for 2022-2025. The key engagement themes included in the strategy were developed following engagement with Partner Funds. After considering the responses to the engagement, the following themes were agreed.

    - Climate transition

    - Waste and water

    - Social/supply chain

- Diversity of thought

The Fund is supportive of these themes.

38. For the past few quarters, the Fund has been collecting data from the quoted equity and bond managers of the carbon exposures of each mandate and how they compare to an appropriate index or benchmark. The intention is to keep this as a high-profile issue with the managers and ensure the Fund engages with them on this subject.

39. The position as at December 2022 is shown in the table at **Appendix A**. The table shows the contribution to the 2022 total fund carbon footprint for each portfolio along with proportion of each portfolio as a percentage of the total fund value. These are backward looking metrics but help to show which portfolios have highest carbon exposures.

40. The table covers all the Fund's public market assets but excludes the Alternatives (Private Equity, Infrastructure and Private Debt) and Property portfolios where the carbon data is less reliable.

41. The table also comments on each mandates carbon emissions each quarter compared to the overall investment market in which they operate and how this has changed since the previous quarter. The investment market is made up of the universe of companies which the investment manager could choose to invest in.

42. As a result of the ongoing strong performance of energy companies over the last year, due to the rise in commodity prices, these companies have increased in size relative to the rest of the market in which they operate. This has meant that in most equity markets the carbon exposures have increased over the past year.

43. Of the six active mandates where we have carbon data from the managers, five have lower carbon metrics than the relative investment market.

44. The one active mandate where the carbon metrics of the Portfolio are higher than the emissions from the market in which they invest, is the Lazard Japanese equity Portfolio. Officers have discussed this position in detail with Lazard and are satisfied with the explanations, which include views on the how the high carbon metrics in the Portfolio are looking to reduce their carbon footprint.

45. This is the third quarter the Fund has received data from Border to Coast on the Corporate Bonds mandate but information on the Multi Asset Credit fund is not yet available as this is a relatively new product and the data quality has not yet been established.

46. Within the Legal and General passive funds it is noticeable that the carbon footprint for the six Future World funds is lower than traditional market cap index funds and the investment markets which they relate to. This lower carbon exposure was one of the main reasons why the Fund invested in these products.

47. From 1st May 2022 several changes are being introduced to the ESG Index range as follows:

    - Addition of Biodiversity as a 30th Metric within the ESG Score
    - Updated Legal and General Future World Protection List (FWPL)
    - Introduction of decarbonisation pathway within the Future World Index Range

48. The current Future World Protection List excludes companies involved in the mining and extraction of Thermal Coal at a 30% revenue threshold. This list has been enhanced to exclude any companies involved in thermal coal power generation at a 20% revenue threshold and companies that derive more than 20% revenue from Oil Sands.

49. Legal and General are also introducing a decarbonisation pathway to reduce the carbon emissions of the Future World ESG Index by 50% relative to its parent index (using 2021 as the base year), and 7% year-on-year thereafter. This change will align the fund to net zero by 2050.

50. By the very nature of the market cap indexed funds, which invest in every company in each respective market, their carbon exposures are in line with those markets.

51. The Fund also has one global fundamental indexed fund which weights individual stocks in relation to a range of measures such as sales, cash flow dividends and book value. This type of index has a higher carbon exposure than the traditional market cap index and the overall market.

52. Legal and General announced in 2021 that it will be transitioning the benchmark for this fund over the next few years to reduce the carbon exposures to levels similar to a traditional market capitalisation index. Further opportunities to reduce carbon emissions from this Portfolio are being considered as part of the 2022 Review of the Investment Strategy.

53. Regarding the Property Portfolio, further engagement has been undertaken with Abrdn and work has been commissioned to develop a net zero pathway for the assets held in the Property Portfolio. The outcome of this work was initially presented to Pensions Committee in February 2022 and a further update will be provided at the Training event

in February 2023. Implementation against the actions set out in this analysis will be monitored and reported back to Committee. This will help inform future decisions around property purchases and capital expenditure.

54. In addition to carbon metrics, the Fund requires all its active managers to identify the top 3 companies in the following categories:

    - Carbon exposures by company in each Portfolio with a rationale for holding these stocks.
    - Fossil fuel exposures by company in each Portfolio with a rationale for holding these stocks.
    - Companies with the highest green revenues.

55. The managers are asked to justify why they are holding these companies and how they are addressing the risks and opportunities that arise from climate change.

56. A similar approach is adopted for the passive funds, including the Future World funds. These funds are required to hold all the companies within the index in which they are benchmarked against. Therefore, the manager has very limited influence on stock selection. Nevertheless, the manager still has a role to play in actively engaging with these companies to drive change.

57. The largest emitters are predominantly Energy, Mining and Steelmaking companies. The managers have provided a rationale for holding these companies which includes an explanation of how these companies plan to decarbonise. These positions are challenged by the Officers each quarter to ensure the companies are making progress.

**Prepare for the implementation of reporting disclosures for the Taskforce on Climate-Related Financial Disclosures (TCFD)**

58. TCFD is a holistic framework for the disclosure of climate-related risks and opportunities. It is currently a voluntary framework utilised to various degrees by corporate entities. The framework has a number of dimensions including governance, strategy, scenario analysis, risk management, metrics and targets.

59. In September 2022, the Department for Levelling Up, Housing and Communities issued the anticipated consultation document on the proposals to require LGPS Funds to assess, manage and report on climate-related risks in line with the Taskforce on Climate-Related Financial Disclosures (TCFD).

60. In summary, it is proposed that Funds will produce an annual Climate Risk Report from 2023/24 with the first report required by December 2024. Four specific metrics have been defined which Funds will be expected to report against annually. The metrics are largely in line with those already identified by the Fund.

61. The proposed requirements are similar to the current requirements for private sector schemes, although are slightly simplified and apply to LGPS funds of all sizes (rather than the phased approach for private pension schemes). The regulations are expected to be in force by April 2023, with the deadline for the first report being 1 December 2024.

62. The Fund submitted its own response to the consultation after consideration of the draft responses issued by Border to Coast and LAPFF.

63. At the last Committee meeting in November 2022 the Fund approved its first TCFD Report. Two years ahead of the expected compliance date. The Report was produced with the support of Hymans Robertson and has now been published on the Fund's website.

64. Border to Coast has also published their 2021/22 TCFD Report which sets out how they are addressing climate related risks and opportunities.

**Recommendations**

65. The Committee is recommended to note the report.

**Reason for Recommendation**

66. To develop the Funds approach to managing ESG and Climate Change Risks.

## Appendix A

## Comparison of Carbon Footprint of the individual Quoted Equity and Bond Mandates to the Investment Markets as at 31 December 2022

| Manager | Portfolio | Style | Proportion of Quoted Assets 2022 | Contribution to 2022 Carbon Footprint | Compared to Investment Market | Quarterly Emissions Increase/ Decrease |
|---|---|---|---|---|---|---|
| **ACTIVE** | | | | | | |
| Border to Coast | UK Equity Alpha | Active | 4.9% | 3.3% | Lower | Increase |
| Border to Coast | Global Equity | Active | 10.3% | 6.3% | Lower | Increase |
| Border to Coast | Corporate Bonds | Active | 21.1% | 12.1% | Lower | Decrease |
| Border to Coast | Multi Asset Credit | Active | 6.7% | 18.1% | N/A | N/A |
| JP Morgan | EMAP Equity | Active | 1.6% | 1.6% | Lower | Decrease |
| Lazard | Japan Equity | Active | 2.9% | 3.7% | Higher | Increase |
| TT | Asia Pacific Equity | Active | 1.4% | 2.0% | Lower | Decrease |
| **PASSIVE** | | | | | | |
| Legal & General | UK Equity Index | Passive | 5.4% | 4.6% | Equal | Increase |
| Legal & General | N America Equity Index | Passive | 4.8% | 4.9% | Equal | Increase |
| Legal & General | Euro Equity Index | Passive | 7.1% | 6.1% | Equal | Increase |
| Legal & General | Japan Equity Index | Passive | 2.2% | 1.2% | Equal | Decrease |
| Legal & General | Asia Pacific Equity Index | Passive | 2.0% | 3.4% | Equal | Increase |
| Legal & General | EM Markets Equity Index | Passive | 2.5% | 5.6% | Equal | Increase |
| Legal & General | Corporate Bonds | Passive | 5.3% | 3.1% | Equal | Decrease |
| **FUTURE WORLD** | | | | | | |
| Legal & General | UK FT World | Passive | 2.3% | 1.5% | Lower | Decrease |
| Legal & General | N America FT World | Passive | 2.7% | 1.2% | Lower | Decrease |
| Legal & General | Euro FT World | Passive | 2.2% | 1.0% | Lower | Increase |
| Legal & General | Japan FT World | Passive | 0.7% | 0.2% | Lower | Decrease |
| Legal & General | Asia Pacific FT World | Passive | 0.8% | 0.7% | Lower | Increase |
| Legal & General | EM Markets FT World | Passive | 0.7% | 0.7% | Lower | Increase |
| **FUNDAMENTAL** | | | | | | |
| Legal & General | Global FTSE RAFI | Passive | 12.4% | 18.7% | Higher | Decrease |
| | | | | | | |
| **TOTAL PUBLIC MARKETS** | | | 100.0% | 100.0% | | |

N/A expected to be availabe later in 2023

# Climate Change and Carbon Metrics

**The following is a list of the background papers (excluding exempt papers) relied upon in the preparation of the above report:**

| Background Paper | File Ref: | File Location |
|---|---|---|
| Managers' Monitoring Files | | Investments Office, South Shields Town Hall |

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