South Tyneside Council

Local Pension Board

Date: 27th March 2024

Climate Change and Carbon Metrics

(for information and discussion)

Report of the Head of Pensions

Purpose of Report

1. Attached is a report to Pensions Committee from 7th March 2024 for the Board's information. The report provides an update on progress against climate related actions in the 2023/24 Service Plan, including defining appropriate carbon metrics and working with the Fund's Investment Managers to ensure they are addressing the Fund's climate change ambitions and specifically seeking to improve data quality and coverage.

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: Paul McCann, Head of Pensions

South Tyneside Council

Pensions Committee

Date: 7th March 2024

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 2023/24 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.

7. The Committee is recommended to note this report.

Contact Officer: Paul McCann, Head of Pensions

Background

8. The Fund has had a significant focus on climate change in recent 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 (excluding carbon reduction targets)
   - A net zero carbon target for the Investment Portfolio of “2050, or sooner”
   - A net zero carbon target for the administrative functions of the Pensions Service 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 carbon reduction targets every three years (next due November / December 2024).

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 2023/24 to 2025/2026

11. The Fund approved a Service Plan at its meeting in January 2023 for the period 2023/24 to 2025/26. This covered several 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:

- Undertake an annual review of the Climate Change Policy (excluding carbon reduction targets).
- Undertake an annual review of the Net Zero Roadmap and set out the progress against the actions.
- Undertake an annual carbon footprint analysis and report against the Fund’s agreed metrics.

- Continue to assess the role of private markets in managing climate risk.

- Continue to assess the 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.

- Produce an annual report on the Taskforce on Climate-Related Financial Disclosures (TCFD).

- Review suitable multi factor investment products with strong climate change credentials.

- Review the options for investing in “green” bonds.

- Continue to keep the climate change scenario analysis under review.

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

Review of Climate Change Policy and Net Zero Roadmap

14. 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 carbon reduction targets every three years.

15. This review forms 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 in December 2023.

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 December 2023. The Roadmap sets out a range of actions that need to be taken to deliver the Fund’s medium and long-term targets on carbon reductions.

17. The Net Zero Roadmap actions are monitored on an ongoing basis to ensure progress is being made. An update on the Roadmap was brought back to the Committee in December 2023, alongside the revised Climate Change Policy and updated Carbon Footprint Analysis.

Undertake an annual carbon footprint analysis

18. The Fund's first carbon footprint exercise was undertaken in 2021. This used 2019 as a base year for future comparison. A high-level carbon footprint was also established back to 2010.

19. Hymans Robertson has undertaken an updated carbon footprint analysis as at 31st March 2023. This was included in the agenda for the Committee meeting in December 2023. It showed that the carbon footprint had now fallen by over 39% from 2019 to 2023 and the Fund was 21% below the benchmark level. This is excellent progress, and the Fund has now achieved its first interim carbon emissions reduction target of a 30-35% reduction in 2025 two years early.

20. 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 in data quality.

21. The results of the carbon footprint analysis are formally reported in the annual TCFD Report which was also approved by the Committee in December 2023.

22. Hymans Robertson will present the Fund's carbon footprint analysis to the Pensions Committee and the Local Pension Board at the training in February 2024.

Continue to assess the role of private markets in managing climate risk

23. This action is ongoing and was also included in the previous year's Service Plan. 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 are working alongside a company called Albourne to review the ESG and climate change credentials of their current and potential private market managers. This work remains ongoing.

26. The Local Authority Pension Fund Forum (LAPFF) agreed to look at this area as part of its 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.

Continue to assess the 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; and

    - 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 Fund’s 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.

34. 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.

35. It should be also noted that exclusion / divestment by the Fund acting unilaterally is unlikely to be achievable for pooled assets.

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

36. 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.

37. 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.

38. In 2021, the Fund sent out a questionnaire to its investment managers to get a better understanding of the approach the managers adopt. This proved helpful in understanding the approach taken by each manager.

39. 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.

40. In July 2023 Border to Coast issued the draft 2022/23 Responsible Investment and Stewardship Report to partner funds. The report highlights the activities of the past year including clarification and strengthening of the voting position on critical issues like climate change and DE&I (diversity, equality and inclusion). During the year Border to Coast published their Net Zero Implementation Plan detailing how they will deliver on the 2050 Net Zero commitment.

41. For the past few years, 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.

42. The position as at December 2023 is shown in the table at **Appendix A**. The table shows the contribution to the 2023 total fund carbon footprint

for each portfolio along with the proportion of each portfolio as a percentage of the total fund value. These are backward looking metrics but help to show which portfolios have the highest carbon exposures.

43. 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.

44. The table also comments on each mandate's 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 in which the investment manager could choose to invest in.

45. Following the production of the carbon footprint analysis, the Fund will continue to encourage its managers to constantly improve the data quality available to produce the agreed carbon metrics. This will take years to fully achieve the desired level of data but consistent improvement each year will ensure the Fund is reporting the most accurate position possible and hence be better informed about the progress being made against each metric.

46. In advance of the 2023 carbon footprint analysis, each of the Fund's main private market managers were contacted requesting carbon metric data in line with the Fund's agreed metrics. The responses provided were assessed by Hymans and follow up meetings arranged where necessary. The Fund recognises that it will take time to achieve the level of data expected and will work with each manger to ensure progress is made.

47. With regard to the commercial property portfolio, further engagement has been undertaken with Abrdn and work was commissioned on developing a net zero pathway for the assets held. The outcome of this work was presented at the training event in February 2023. Implementation against the actions set up in this analysis will be monitored and reported back to Committee.

48. In May 2023, the LGIM ESG Score was updated through the addition of four new ESG metrics split between the E and G score pillars. These additions take the number of metrics within the ESG Score to 34. The new additions are:

- Deforestation Programme
- Water Management Programme
- Value Chain Emissions Intensity (Scope 3 Emissions)
- Climate Lobbying (to be named 'Lobbying Activities')

49. There will also be a relaxation of index methodology constraints to allow for more efficient implementation of ESG objectives, such as decarbonisation pathways.

50. 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.

51. Legal and General also introduced 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.

52. 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 of markets.

53. 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.

54. 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.

55. 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.

56. 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. A separate report has been prepared for members of the Committee which provides further information on these Top 3 positions across the Fund's listed equity and fixed income portfolios. This report can be found on the secure extranet.

Produce an annual report on the Taskforce on Climate-Related Financial Disclosures (TCFD)

57. 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.

58. 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).

59. In summary, it was proposed that funds 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.

60. A formal response to the consultation is expected in the Summer and the final outcome will be shared with Committee. There are not expected to be any significant changes to the original consultation, although there has been some suggestion that the timescale above may slip. Officers will monitor the position and keep Committee informed of developments. Notwithstanding this, the Fund will continue with its own TCFD reporting, even in the absence of a legal requirement to do so.

61. At the 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. An updated TCFD Report was brought to the Committee meeting in December 2023 and subsequently published.

62. Border to Coast has now published their Climate Change Report 2022/23 which sets out how they are addressing climate related risks and opportunities. This is the new name of the TCFD Report and reflects on advances made towards achieving the Net Zero 2050 or Sooner commitments and links to their Net Zero Implementation Plan. A copy of the report can be found on their website and copies are available from Officers.

Review suitable multi factor investment products with strong climate change credentials

63. One of the recommendations in the 2022 Investment Strategy review was to identify and evaluate alternatives to the Legal and General RAFI Global

Reduced Carbon Pathway Equity Index fund. This is a single factor-based approach and, despite the name, has a higher carbon footprint than the Fund's other equity mandates.

64. It was agreed in the Strategy Review that a multi-factor product which covers a range of factors would give a more balanced risk and return for the Fund.

65. Discussions have taken place with Legal and General and a presentation was made at the training event in September 2022, which focussed on two potential alternative funds. Subsequently Legal and General indicated they were preparing to launch their own multi-factor climate transition fund which would be part of the Future World series of funds. Further work is ongoing in this area and Officers will provide an update once the details of the new Legal and General fund are known.

66. Legal and General are not alone in developing their own multi-factor ESG product as Border to Coast is now also active in this space. A proposition of this nature has been included as an action for 2024/25 in the Strategic Plan and Border to Coast recently held a workshop on this. It is appropriate to work with Border to Coast on the development of its product, although conversations will also continue with Legal and General.

Review options for investing in "Green" Bonds

67. Border to Coast held workshops on this area in December 2022 and May 2023. The global market for these types of bonds is still developing but is expected to grow significantly over the next few years. Border to Coast have scheduled the development of a global Green, Social or Sustainable (GSS) Bond fund for 2025/26.

68. Tyne and Wear have expressed the view that "green bonds" should initially be incorporated as an allocation in existing fixed income products such as UK Corporate Bonds and Multi Asset Credit (MAC). Border to Coast believe that a new product is preferable as the level of issuance in the UK market is limited and they would not be sufficient to meet the Net Zero ambitions.

69. Currently the fixed income funds offered by Border to Coast have a UK focus where there is only a small and immature market for GSS bonds. Globally GSS bonds now account for 15% of new issuance and this figure is increasing rapidly. Border to Coast have held initial discussions with a range of external managers to learn more about management structures, capacity and fees.

Continue to keep the Climate Change Scenario Analysis under review

70. An update of the Climate Change Scenario Analysis was presented to the Pensions Committee and the Local Pension Board on 15th July 2022.

71. The analysis was undertaken on different climate change scenarios and how effective the strategy may be under those scenarios.

72. A summary of the observations coming out of the analysis suggests the 2022 investment strategy is unlikely to be significantly impacted by any of the three climate scenarios considered which indicates it is resilient to climate change risk.

73. It is important that, in absence of a strong belief of which climate scenario we may experience, that the Fund continues to remain well diversified across a range of investments that will do well during different climate outcomes.

74. In summary, the Fund is considered to be in a good position to manage the risks arising from climate change, but the position needs to be continually monitored. No specific additional action is needed, other than the actions already contained in the Service Plan and those detailed in the 2022 Review of the Investment Strategy.

Recommendations

75. The Committee is recommended to note the report.

Reason for Recommendation

76. To develop the Fund’s 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 2023

Manager	Portfolio	Style	Proportion of Quoted Assets	Contribution to 2023 Carbon Footprint	Compared to Investment Market	Quarterly Emissions Increase/ Decrease
ACTIVE						
Border to Coast	UK Equity Alpha	Active	5.3%	2.6%	Lower	Decrease
Border to Coast	Global Equity	Active	11.6%	9.0%	Lower	Decrease
Border to Coast	Corporate Bonds	Active	24.2%	13.4%	Higher	Increase
Border to Coast	Multi Asset Credit *	Active	7.0%	24.0%	N/A	N/A
JP Morgan	EMAP Equity	Active	1.6%	0.9%	Lower	Decrease
Lazard	Japan Equity	Active	3.2%	3.1%	Lower	Decrease
TT	Asia Pacific Equity	Active	1.4%	1.2%	Lower	Increase
PASSIVE						
Legal & General	UK Equity Index	Passive	3.2%	2.6%	Equal	Decrease
Legal & General	N America Equity Index	Passive	4.6%	4.7%	Equal	Increase
Legal & General	Euro Equity Index	Passive	6.1%	5.6%	Equal	Increase
Legal & General	Japan Equity Index	Passive	1.9%	1.2%	Equal	Increase
Legal & General	Asia Pacific Equity Index	Passive	1.9%	3.3%	Equal	Increase
Legal & General	EM Markets Equity Index	Passive	2.4%	5.1%	Equal	Increase
Legal & General	Corporate Bonds	Passive	5.8%	3.5%	Equal	Decrease
Legal & General	Index Linked Gilts	Passive			Equal	Decrease
FUTURE WORLD						
Legal & General	UK FT World	Passive	2.6%	0.9%	Lower	Increase
Legal & General	N America FT World	Passive	2.6%	1.3%	Lower	Decrease
Legal & General	Euro FT World	Passive	2.6%	1.4%	Lower	Decrease
Legal & General	Japan FT World	Passive	0.7%	0.3%	Lower	Increase
Legal & General	Asia Pacific FT World	Passive	0.8%	0.6%	Lower	Decrease
Legal & General	EM Markets FT World	Passive	0.7%	0.9%	Lower	Increase
FUNDAMENTAL						
Legal & General	Global FTSE RAFI	Passive	9.8%	14.4%	Higher	Increase
TOTAL PUBLIC MARKETS			100.0%	100.0%		

N/A expected to be availabe later in 2024

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

Contact Officer: Paul McCann, Head of Pensions