AGENDA ITEM
8

Environmental, Social and Governance (ESG) Policy Review

Agenda Item 8

<u>Falkirk Council</u>

Title:	**Environmental, Social and Governance (ESG) Policy Review**
Meeting:	**Joint Meeting of Pensions Committee and Pension Board**
Date:	**16 March 2017**
Submitted By:	**Director of Corporate and Housing Services**

1. Purpose of Report

1.1 This report is a follow up to the paper presented to the joint meeting of Committee and Board in December 2016 which considered ways in which the Fund's approach to Environmental, Social and Governance (ESG) matters could be developed.

2. Recommendations

2.1 The Pensions Committee and Pension Board are asked to note the actions being taken forward in relation to the Fund's policy on ESG matters.

2.2 The Pensions Committee is asked to agree:

a) to the adoption of the additional belief statements as set out in paragraph 4.2;
b) to a carbon footprinting exercise being carried out by Trucost as set out in paragraph 4.6; and
c) to the Statement of Investment Principles being updated in line with the agreed decisions from both this and the December meetings.

3. Background

3.1 ESG encompasses a variety of risks including those relating to environmental stewardship, corporate governance and social policy.

3.2 The scheme rules require Funds to maintain a Statement of Investment Principles (a "SIP") stating how ESG considerations will be taken into account in the investment process.

3.3 The Falkirk Fund's current approach to ESG is set out in the Fund's SIP and has in the past, placed a particular emphasis on

- Corporate environmental policy
- Human Rights
- Employment Standards (incl Executive pay)

3.4 Over recent months, the Committee has been considering how to develop the Fund’s approach to ESG. This has been informed by work undertaken by the investment sub group work; a seminar hosted by the Fund in November 2016 and ongoing support and guidance from the Fund’s investment adviser.

3.5 The legal purpose of the Fund is to provide benefits for members and minimise costs for employers. The Fund’s approach to ESG must therefore be consistent with this legal purpose and not be in pursuit of any purely ethical aim.

3.6 Most recent legal opinions suggest that:

- trustees should pursue the best financial position for their Fund (balancing risk and return); and
- the precise choice of investment can be influenced by wider social, ethical or environmental considerations, so long as that is not to the material financial detriment of the Fund

3.7 At the joint meeting of December 2016, it was agreed that the Fund would:

- review its statement of beliefs in relation to ESG matters
- monitor the carbon exposure of the portfolio on a regular basis using third party specialists in order to better understand the associated risks
- engage to a greater extent with Managers regarding their exposure to fossil fuel companies
- sign up to a responsible investment code (e.g. the UK Stewardship Code)
- report quarterly on voting undertaken by PIRC
- ensure that in any new manager search, the manager’s ability to deliver sustainable long term growth is a priority
- consider making an allocation within the portfolio to a fund which tracks a low carbon index or has sustainability and long term returns at its core

3.8 It is expected that discussions will be further informed by the training session on 10 March at which an ESG presentation will be delivered by Faith Ward, Chief Responsible Investment and Risk Officer with the Environment Agency Pension Fund.

4. Progress to Date

Statements of Belief

4.1 At the December meeting, the Pensions Committee agreed to review the Statement of Beliefs in relation to ESG matters.

4.2 Following discussions with Hymans Robertson, the Investment Adviser, it is proposed to introduce two further beliefs to place a greater emphasis on ESG risks and, in particular, climate change risk:

"We must act as responsible owners

"As asset owners in the 21st Century, we believe it is our responsibility to support the transition to a low carbon global economy, consistent with the aims of the Paris 2016 Climate Change agreement to limit temperature increases by 2050 to a maximum of 2oC."

"Ongoing engagement is preferable to divestment"

"The Committee believes that, in relation to ESG risks, ongoing engagement with investee companies is preferable to divestment. This engagement may be via our managers or alongside other investors (e.g. LAPFF). Where, over a considered period, however, there is no evidence of a company making visible progress towards carbon reduction, we believe that divestment should be actively considered."

Measuring the Carbon Footprint

4.3 The December meeting of the Committee also agreed that the Fund should measure the carbon exposure of the portfolio on a regular basis. This is with a view to assessing whether:

- the Fund's assets are consistent with the goal of limiting global temperature increases to not more than 2oC by 2050 (as articulated in the proposed belief statement in 4.2), and whether
- there is a case for energy stocks to be transitioned out of the portfolio on the basis that their business models may be unsustainable under the global 2oC Climate Change agreement (i.e. "stranded assets").

4.4 The investment adviser has obtained costings from several providers for the carbon footprinting exercise:

- Trucost
- MSCI
- Sustainanalytics
- Your SRI

4.5 Details of each provider's services are contained in the Hymans Robertson paper which is attached at Appendix 1.

4.6 Hymans recommend using Trucost on the basis that they have experience of working with LGPS clients and their proposal includes measuring Scope 1, 2 and 3 emissions; delivering results at both a portfolio and aggregate level; and meeting with the Fund to discuss the results.

4.7 The monitoring of the Fund's exposure to carbon and the way in which consequential risks might be mitigated are matters that could be addressed through a common approach with collaborative partners (e.g. the proposed shared service agreement with the Lothian Fund).

Voting

4.8 Pension Fund voting records - as undertaken by PIRC on the Fund's behalf – are now being uploaded to the Fund website.

Other Matters

4.9 In relation to adopting one of the responsible investment codes (e.g. the UK Stewardship Code), this will be progressed in the coming months.

4.10 With regard to the possibility of making an allocation to a Fund which tracks a low carbon index, the advice from Hymans Robertson, the Investment Adviser, is that more time is needed in order to assess the value and benefit of what are relatively new products. Therefore, for the moment, an allocation is not being recommended.

4.11 Subject to the recommendations being agreed, the matters outlined in this section will be incorporated into the Statement of Investment Principles with the updated version being brought to a future meeting of the Committee and Board.

5. Implications

Financial

5.1 The Carbon Footprinting recommendation for which there is provision in the draft Fund budget will result in additional costs of around £9,500 p.a. (assuming the process is repeated annually).

Resources

5.2 The ongoing monitoring of the Fund's carbon exposure is an additional administrative overhead and will require to be absorbed within staff time.

Legal

5.3 LGPS rules require Funds to maintain a written Statement of Investment Principles (the "SIP") specifying the extent to which social, environmental or ethical considerations are taken into account in selecting and retaining investments.

Risk

5.4 Failure to take sufficient notice of ESG risks, such as climate change, could lead to claims that the Fund is potentially failing in its fiduciary duty.

Equalities

5.5 There are no equality issues arising from the proposals.

Sustainability/Environmental Impact

5.6 The subject matter of this report includes the risk to the Pension Fund from climate change. The recommendations in the report are designed to allow the Fund to better understand its carbon risk exposure

6. Conclusions

6.1 The report sets out the decisions taken by the Pensions Committee in relation to managing ESG risks. Subject to Committee agreement, the decisions will be incorporated within the Statement of Investment Principles and officers will take forward the agreed actions.

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Director of Corporate and Housing Services

Author : Alastair McGirr, Pensions Manager, 01324 5066333
alastair.mcgirr@falkirk.gov.uk

Date: 8 March 2017

Appendices

Appendix 1 – Hymans Robertson paper on Carbon Footprinting

List of Background Papers:

- None

Carbon footprinting

This paper is addressed to Officers of the Falkirk Council Pension Fund (“the Fund”). It should not be disclosed to any other third parties without our prior written permission and then only in full. We accept no liability to third parties unless expressly accepted in writing. The Fund is seeking to understand the level of carbon risk exposure within its equity portfolio. Quotes were sought from four potential providers to undertake a carbon footprinting exercise across the Fund’s five equity portfolios.

An outline of the responses provided is set out as an Appendix with some further comments set out below. The four providers approached were:

- **Trucost**: A firm with over 14 years’ experience in quantifying and evaluating natural capital impacts and risk data. The firm is now owned by S&P Dow Jones Indices.
- **MSCI**: A global provider of index solutions and analytics.
- **Sustainalytics**: An independent provider of ESG and corporate governance research and ratings.
- **YourSRI**: A database and research engine for ESG and carbon reporting and part of the Centre for Social and Sustainable Products, a consulting and research firm focused on responsible investment.

In our view, there are three relevant factors in the selection of a provider:

1 **Methodology**. All four providers offer broadly similar approaches, using reported and estimated carbon emissions data on a broad universe of companies as the basis for their analysis. Trucost and YourSRI offer access to some Scope 3 data which may be regarded as more comprehensive although the quality of this data may be questionable. The Fund would therefore be reliant on the estimation methodologies. Coverage by YourSRI is substantially greater than other providers (c40,000 companies data noted as being included in their database) compared to others in the range of 6500 to 9000 companies.

2 **Reporting**. Of the four providers, only Trucost have proposed reporting on the equity portfolio at an aggregate level. Whilst data from the other providers could be aggregated, this would represent an additional cost. Three of the providers MSCI, Sustainalytics, YourSRI) offer only standard reporting although some tailoring may be available. Further, two of the providers (Sustainalytics and YourSRI) offer limited/no commentary/interpretation of the data provided. The level of detail in the reporting also varies with some providing analysis of fossil fuel exposure, energy transition exposure and sector/stock attribution as standard whilst this is not included/additional for others.

3 **Fees**. Fees for the provision of portfolio analysis across five equity portfolios range from c£5,000 to c£15,000 (plus VAT). However, fees should be set against the service being provided and the additional work that may then be necessary. Sustainalytics proposed the highest fee whilst YourSRI proposed the lowest fee although in each case, further work will be needed in order to interpret the results of the analysis and determine the actions to be undertaken.

MSCI proposed a fee of £6,250 for the exercise. Whilst lower than the fee proposed by Trucost (£9,500), the service offering from Trucost is more encompassing and can be tailored to the needs of the Fund. Trucost have also offered to meet with the Fund to discuss the results of the analysis..

In our view, the proposal from Trucost seems most comprehensive although their fee is slightly higher than that proposed by MSCI. Further, Trucost have experience of working with a number of other LGPS funds, including Strathclyde. We therefore believe that the Fund would gain most value from engagement with Trucost on this exercise.

Prepared by:-

Simon Jones, Senior Investment Consultant

February 2017

For and on behalf of Hymans Robertson LLP

General risk warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets.

Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix: Summary of responses

	Trucost	MSCI	Sustainalytics	YourSRI (South Pole Group)
Coverage	Scope 1 and 2 plus Scope 3 (immediate supply chain only) Coverage of c6500 companies (reported/estimated data) Include aggregate portfolio report	Coverage of c8500 companies Scope 1 and 2 emissions only	Use reported data on 2000 companies and estimated data on c7000 companies. Scope 1 and 2 data only	Coverage of around 40,000 companies Scope 1 and 2 data plus scope 3 at a portfolio level
Reporting	**Tailored** Includes carbon footprint, stock and sector attribution, fossil fuels, energy transition Aggregated assessment of portfolio and recommendations for action	**Standard** Includes carbon footprint, stranded asset exposure, level of carbon risk mgmt., exposure to clean tech.	Two **standard** reports available Emissions data file: includes scope 1 and 2 emissions and portfolio carbon footprint Portfolio analytics report: includes comparators with benchmark and attribution analysis	**Standard** Includes carbon footprint, attribution analysis vs benchmark but limited commentary and interpretation
Data required	Holdings and benchmark data ISIN Company name Value/weight	Security identifier (ISIN etc) Portfolio weight Benchmark	Holdings and benchmark data Security identifier Portfolio weight	Holdings data only Security identifier (ISIN etc) Company name Portfolio weight
Timeframe	4-6 weeks	1-2 weeks	3 weeks	1-2 weeks
Fees (ex VAT)	£9,500 (discounted from standard fee of £12,000)	£1,250 per report Total fee of £6,250	£9,800 (emissions data files only) £15,400 (portfolio analytics reports)	EUR890 per portfolio plus EUR100 per report for data export Approx. total fee of £5,000
Notes	Fee includes a meeting to explain results Have provided carbon footprinting services to other LGPS including Environment Agency and Strathclyde	Fees based on LGPS framework rate Can gain online information via subscription to the ESG manager platform	Have assumed coverage of all holdings Reporting is via data files only with little interpretation/commentary on analysis being provided as standard Can provide further information on fossil fuel involvement and stranded asset risk, but not included as standard	Provision of data analysis only Underlying client base for this service is predominantly asset managers