Agenda Item 8

ESG Update

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Falkirk Council

Subject: **ESG Update**

Meeting: **Joint Meeting of Pensions Committee and Pension Board**

Date: **7 December 2017**

Submitted by: **Director of Corporate and Housing Services**

1. Purpose of Report

1.1 This report updates the Committee and Board on recent requests from constituents for the Fund to divest from fossil fuel companies.

2. Recommendation

2.1 The Committee and Board are asked to note the contents of the report

3. Background

3.1 Scheme rules require the Fund to maintain a Statement of Investment Principles ("SIP") stating how Environmental, Social and Governance (ESG) considerations will be taken into account in the investment process.

3.2 In the past two years, the Fund has had a particular focus on environmental stewardship and the challenges of climate change, as evidenced by:

- work undertaken by the investment sub group in 2015;
- a seminar for Fund stakeholders in November 2016;
- a presentation to Committee and Board members in March 2017 by Faith Ward, Chief Responsible Investment and Risk Officer of the Environment Agency Pension Fund; and
- ongoing Committee and Board discussions

3.3 This has led to the Committee agreeing to:

- adopt additional ESG beliefs within the SIP;
- undertake a carbon measurement exercise in order to better understand the associated risks;
- engage to a greater extent with Managers regarding their exposure to fossil fuel companies; and
- report quarterly on voting undertaken by PIRC.

4. Fund Investment Beliefs

4.1 The Fund’s Statement of Investment Principles contains a number of core investment beliefs three of which relate to ESG risks. These are as follows:

“Environmental, social and corporate governance (‘ESG’) issues can have a material impact on the long term performance of its investments - the Committee recognises that ESG issues can impact the Fund’s returns and the Committee aims to be aware of, and monitor, financially material ESG-related risks and issues through the Fund’s investment managers. The Committee commits to an ongoing development of its ESG policy to ensure it reflects latest industry developments and regulations.”

“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.”

“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.”

4.2 The SIP contains a number of other beliefs which the Committee recognises must be considered alongside its ESG beliefs, such as:

“Clear and well defined objectives are essential to achieve future success - the Committee is aware that there is a need to generate a sufficient level of return from the Fund’s assets……. …………. to pay members’ benefits as they fall due.”

5. Recent Lobbying and Legal Position

5.1 A number of elected members have recently received standardised e-mails from constituents expressing concern at the Fund’s investments in fossil fuel companies. It is understood that they originate from the Friends of the Earth (FoE) website where the invitation to lobby a Councillor is available. The email urges the elected member to support pension fund divestment from fossil fuel companies. A sample of the email is attached at Appendix 1, together with the response prepared by officers.

5.2 The legal purpose for which the Fund exists is to provide benefits for members and to minimise costs for employers. The Fund’s approach to investment must therefore be consistent with this legal purpose and *not be in pursuit of a particular ethical aim*. As a consequence, the request for Funds to divest unilaterally from fossil fuels is not considered a legally sustainable approach.

5.3 A significant body of legal opinion exists on to the extent to which trustees' can base investment decisions on **non-financial** factors. Some of these opinions are recent (e.g. Law Commission report 2014, Pinsent Mason report to Scottish Scheme Advisory Board 2016). Collectively, they indicate that trustees:

- should pursue the best financial position for their Funds (balancing risk and return);
- can allow their choice of investments to be influenced by wider ESG considerations, so long as this is not to the material detriment of the Fund; and
- should not base investment decisions on non-financial factors unless they can demonstrate that the majority of stakeholders are similarly minded

6. Carbon Measurement

6.1 The Committee is conscious of public concerns around the issue of climate change and the risks that it poses to the Fund as a whole. It has therefore engaged Trucost to carry out a carbon measurement exercise with a view to understanding more about the nature and the extent of the Fund's carbon footprint.

6.2 The results will shortly become available. These will be reviewed by the Joint Investment Strategy Panel and an update provided to the March meeting of the Committee and Board, together with recommendations for next steps.

7. Implications

Financial

7.1 Inadequate oversight of ESG risks (including climate change risk) could lead to a fall in Fund values and higher contribution rates for employers.

Resources

7.2 None

Legal

7.3 A policy of outright divestment from a company or sector could lead to a legal challenge if fund returns were materially impacted.

Risk

7.4 The Fund may be invested in companies or sectors where there is insufficient oversight of ESG risk, including climate change risk.

Equalities

7.5 None.

Sustainability/Environmental Impact

7.6 In order to achieve good diversification and reduce risk, the Fund is invested in a range of assets some of which will be more carbon intensive than others.

8. Conclusion

8.1 The Fund has adopted various investment beliefs which recognise the importance of ESG within its wider framework of risk control.

8.2 At present, the Fund considers that engagement with managers and companies either directly or through collective bodies such as the Local Authority Pension Funds Forum is the most effective and responsible way in which to seek changes in corporate behaviour.

8.3 The Fund's investment beliefs recognise that divestment may be an option if companies are showing insufficient progress in reducing their carbon footprint

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pp **Director of Corporate & Housing Services**

Author: Alastair McGirr, Pensions Manager
01324 506333 alastair.mcgirr@falkirk.gov.uk

Date: 29 November 2017

Appendix

Sample Email - Fossil Fuel Enquiry

List of Background Papers:

None

Appendix 1

Sample Email - Fossil Fuel Enquiry

Dear Councillor,

I am writing to you as your constituent to express my concern about the investments of our council pension fund in fossil fuel companies and to ask you to support the divestment of the fund.

A new report [1] shows that across Scotland council-managed pension funds are investing more £1.8 billion in oil, coal and gas companies. These investments undermine local and national efforts to address climate change, and represent an unacceptable financial risk to pension-holders.

Two years ago, world governments signed the Paris Agreement – pledging to curb emissions and limit global temperature rise to 1.5 degrees. But the actions of fossil fuel companies like Shell and BP are pushing us far beyond this vital climate threshold.

Since 2015, the world has experienced the warmest year ever recorded and 2017 has brought devastating extreme weather events. Further extraction and burning of fossil fuels is not compatible with tackling climate change, and investing in fossil fuels is deeply irresponsible.

These investments also represent a serious financial risk to council pension funds. The value of fossil fuel companies is based on their reserves, and ability to burn them. But if global climate targets are going to be met, these reserves are 'unburnable'.[2]

Leading financial experts, including the Governor of the Bank of England, Mark Carney, have highlighted the risks of fossil fuels becoming 'stranded assets' and the danger which this poses to funds which continue to invest in them.

Council pension funds should be invested in the long-term interests of their members but they are not well served by risky investments which are driving climate change. Instead, councils could be investing in ways that benefit the local community – like renewable energy infrastructure and green social housing.

Fossil fuel divestment is a practical, legal and responsible way for pension funds to respond to climate change and address financial risk. Over 800 institutions around the world have made divestment commitments, including council pension funds in the UK like Southwark and Waltham Forest.

Local councillors have significant power over the investment decisions of the Local Government Pension Scheme:

1. Do you agree that the council should divest its pension fund from fossil fuels and reinvest in ways that benefits the community?
2. What steps is the council is taking to end fossil fuel investments and invest responsibly?

Yours sincerely,

Constituent

[1] http://gofossilfree.org/uk/fuellingthefire
[2] https://www.carbontracker.org/wp-content/uploads/2014/09/Unburnable-Carb...

Draft Reply from Chief Finance Officer to Friends of the Earth Divestment Email

“Dear xxxxx,

Falkirk Council Pension Fund - Fossil Fuel Investments

I refer to your recent email regarding the Pension Fund’s investments in “fossil fuel” companies.

Whilst I note this has probably been based on standardised text prepared by Friends of the Earth, I recognise that this is a very important subject for many citizens and constituents and welcome the opportunity to set out the Fund’s position.

The Falkirk Fund has assets of approximately £2.3bn of which around £156m (6.8%) is invested in companies that are publicly listed as being in the Oil, Gas or Mining Sectors. A number of these companies also engage in non-fossil fuel generating activities (e.g. renewables), so the Fund’s actual exposure will be less than the headline 6.8%.

In Falkirk Council, decisions on investment strategy are delegated to a Pensions Committee. Members of the Committee act in a quasi-trustee capacity and owe certain legal obligations to the Fund’s 30,000 scheme members and its 35 participating employers.

The most important trustee obligation is what is commonly referred to as the “fiduciary duty” which requires trustees to act in the best interests of Fund stakeholders. This is underpinned by case law and successive legal opinions which have established that:

- trustees should pursue the best financial position for Fund members (balancing risk and return);
- 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; and
- Funds should not base investment decisions on non-financial factors unless they can demonstrate that the majority of members (incl. employers) are similarly minded about the non-financial factor

Achieving good financial returns for an acceptable level of risk is key to the Fund’s objective being able to deliver sustainable and affordable benefits for stakeholders. Outright divestment from a particular sector could, by contrast, lead to poorer financial returns and employers having to make up the shortfall. This is an acute consideration against the backcloth of constrained public funding.

In order to achieve “good” returns in what is a highly complex and technical environment, the Fund uses specialist investment managers to make decisions about stock selection and retention. At present, these managers - with the proven expertise to assess company business models - remain comfortable investing in the Oil, Gas and Mining sectors. This of course may change if the business risks become too great. Against that narrative, the Fund maintains an ongoing dialogue with its investment managers to ensure that they are engaging robustly with investee companies and monitoring the environmental and regulatory risks.

I should also point out – in case it is a source of confusion - that by purchasing shares in oil and gas companies, the Fund is **not** paying monies over to the company itself but is instead paying the seller of the shares. In other words, the company does not benefit from the share purchase. Indeed, being a share owner can be a positive in that the Fund is able to vote at and attend company meetings and potentially - as a responsible asset owner - retain some influence over activities such as fossil fuel production. By contrast, the alternative policy of outright disinvestment could lead to shares being owned by unscrupulous and less principled owners who have no regard for environmental issues.

In practice, company engagement is likely to be done through the Fund’s membership of the Local Authority Pension Fund Forum (LAPFF), which brings together UK local authority pension schemes and other like-minded investors to maximise shareholder influence. In recent times, this pressure has led to the “Aiming for A campaign”– a process of patient engagement which has seen companies such as BP, Shell, Rio Tinto, Anglo

American and Statoil be more engaged around climate change strategy and transparent about their plans for transitioning to a lower carbon world.

In response to the specific questions that were posed in your e-mail,

1) the Fund does not agree that it should divest from fossil fuel related investments at this time;

2) the Fund has recently made changes to its Statement of Investment Principles to place a greater emphasis on climate change risk, including the measurement of the Fund's carbon footprint to assess alignment with the aims of the 2016 Paris climate change agreement. The results of this exercise are expected shortly. The Fund also held an ESG event for its Committee and Board Members in late 2016 at which Ric Lander of Friends of the Earth presented. The Committee has also agreed that divestment from a particular company will be considered if their long term strategy for addressing climate change concerns is not sufficiently convincing.

I hope that this reply helps explain the investment strategy of the Fund and its reasons for continuing to have modest exposure to the Oil, Gas and Mining sectors (albeit these are kept under review)."

Chief Finance Officer