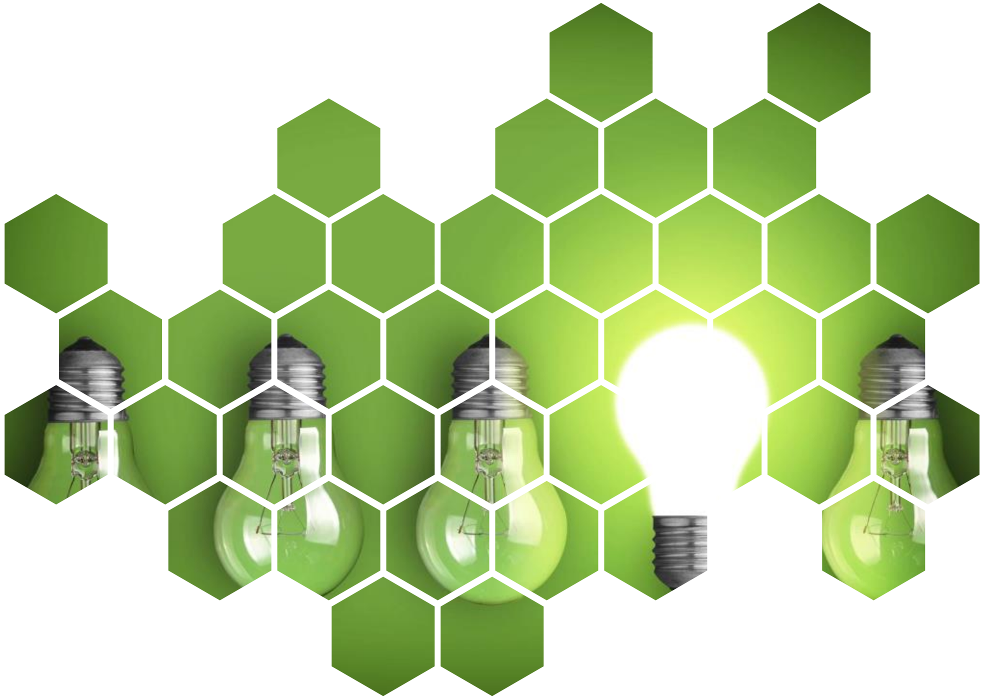
Responsible Investment: Overview and Next Steps



London Borough of Enfield Pension Fund

Prepared for:	The Committee
Prepared by:	Aon
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Background and objectives

Background

- In January 2023, we provided an overview and training of the background to the Responsible Investment (RI) space.
- Today's session is a follow-up to January's discussion, and focuses specifically on:
  - Forthcoming climate risk management requirements
  - The Fund's previously agreed priorities
  - Next steps
- It is an opportune time to re-evaluate the Fund's desired approach and next steps to align with this.

Objective

- This session is intended to:
  - Explain the forthcoming requirements on climate-related risk reporting that will affect the Fund;
  - Explain what other Funds are doing and taking action on;
  - Explain what 'divestment' and 'engagement' approaches are, alongside 'greenwashing'; and
  - Set out what actions the Fund had previously expressed an interest in undertaking, and how this could be done.

Agenda

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Knowledge

Forthcoming regulation: TCFD

2

Knowledge

What other Funds are doing

3

Training

Divestment, engagement, and greenwashing

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Direction

A practical roadmap

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Taskforce on Climate-related Financial Disclosures (TCFD)

Recap: What is TCFD?

The Financial Stability Board created the Taskforce on Climate-related Financial Disclosures ("TCFD") to improve and increase reporting of climate-related financial information.

What is it?

- In 2017, the TCFD released 11 climate-related financial disclosure recommendations about the risks and opportunities presented by climate change. In turn, the framework is designed to help provide better information to support informed capital allocation.
- Mandatory TCFD reporting is now required for corporate pension schemes with more than £1bn in assets. DHLUC consulted in Q4 2022 on the mandatory introduction of TCFD reporting across England & Wales LGPS.
- **The regulation is expected to come in place in April 2023 for the Fund to comply in 2024.**
- Whilst 2024 seems a while away, this is an intensive exercise requiring input from multiple parties.
- **As such, we recommend progressing this now, and have set out an indicative project plan and timeline to inform the Committee.**

"The goal of TCFD…

..financial risks and opportunities related to climate change will become a natural part of risk management and strategic planning.

As this occurs, understanding of the potential financial implications associated with transitioning to a lower-carbon economy and climate-related physical risks will grow; information will become more decision-useful; and risks and opportunities will be more accurately priced, allowing for the more efficient allocation of capital."

Source: Financial Stability Board, Taskforce on Climate-related Financial Disclosures

Objective: better understanding of risk

Scenario analysis

Analyse **at least two** climate-related scenarios in the first year and then every 3 years, with annual review in intervening years.

The Fund is undertaking this in conjunction with your triennial actuarial valuation.

Metrics (minimum)

- Two emissions-based metrics (one absolute measure of emissions and one intensity based measure of emissions), one additional climate related metric, and one **portfolio alignment** metric
- Obtain data and calculate metrics as far as are able on annual basis

1

2

3

4

5

Strategy

Identify and assess on ongoing basis climate-related risks and opportunities which will affect the investment and funding strategy over the **short, medium and long term**

Risk management

Adopt and maintain, on ongoing basis, processes for identifying, assessing and managing climate-related risks and integrate within overall risk management

Targets

Set **at least one target** for one of the chosen metrics and report on progress against this target annually

Funds must have the appropriate **governance** arrangements in place for managing and meeting these requirements.

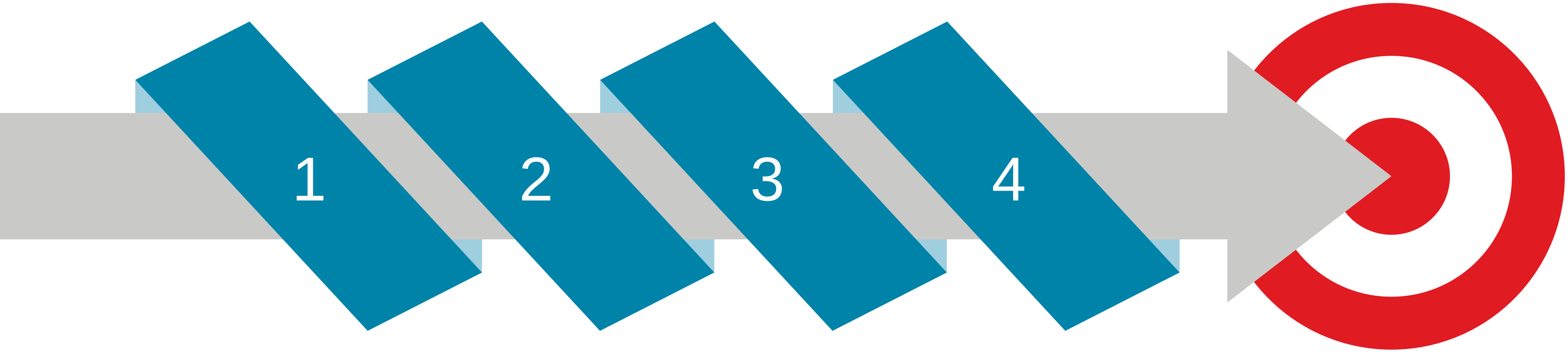
Indicative project timelines

Key takeaway

Developing the Fund's approach will take time, and require input from multiple parties (LCIV; managers; your Fund Actuary; and others). Planning ahead is important, and we recommend beginning this project early.

What are other Funds doing?

Themes of activity



Developing climate risk reporting

Several Funds are gearing up for TCFD; some Funds report on a voluntary basis already.

Examples:

Fund A – establishing a TCFD Action Plan to prepare over an 18-month timeframe

Fund B – already reports, but seeking to enhance.

Interrogation of stewardship action

The Stewardship Code revisions have prompted Funds to consider how they apply the Code's principles across all asset classes.

Examples:

Fund C – not currently a signatory, but planning to apply in 2022

Fund D – 2012 Code signatory; has reapplied under 2020 Code

Net Zero commitments?

Many funds are grappling with a degree of stakeholder pressure to commit to net zero emissions across their portfolio by a specified date.

Examples:

Fund E – Commitment by 2030

Fund F – Adopting a 'wait and see' approach, depending on peer action

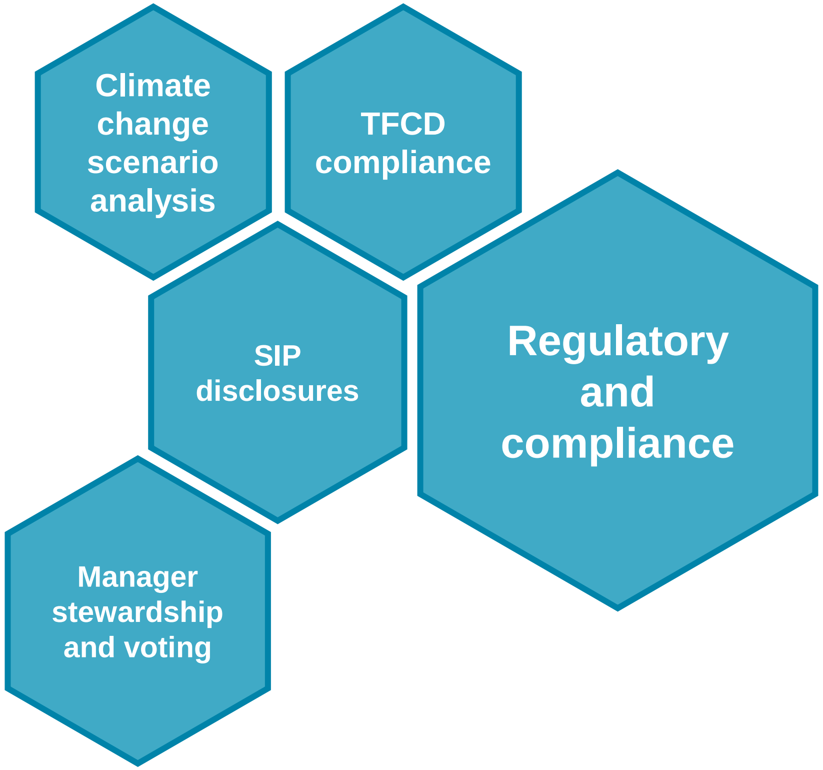
Examining managers' policies

A 'deep dive' into the ESG approach and priorities of appointed managers can help in understanding alignment

Example:

Fund G – Reviewed all managers to examine alignment with Committee beliefs. Changes to allocations made in line with strategy review.

What other Funds are doing



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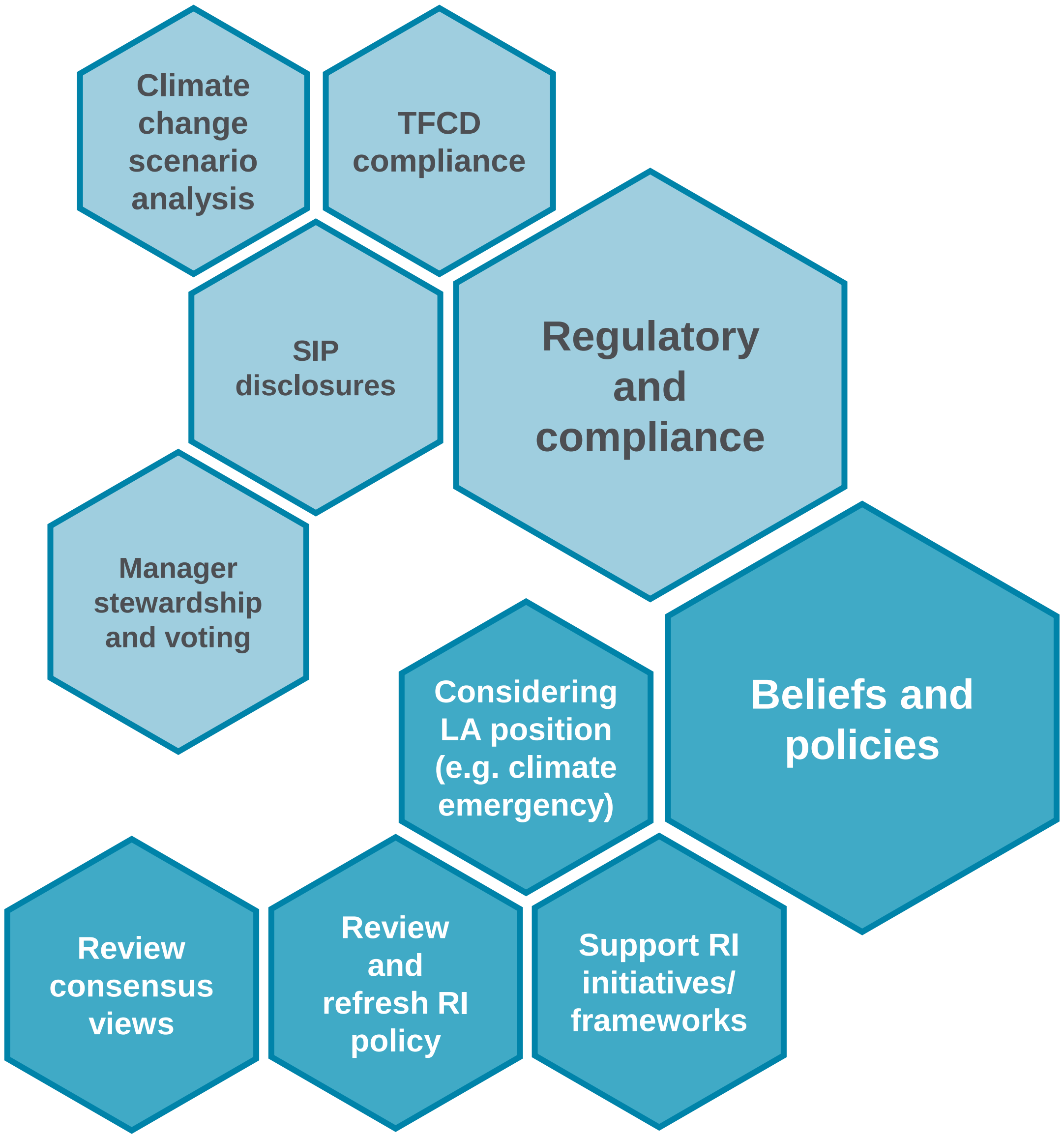

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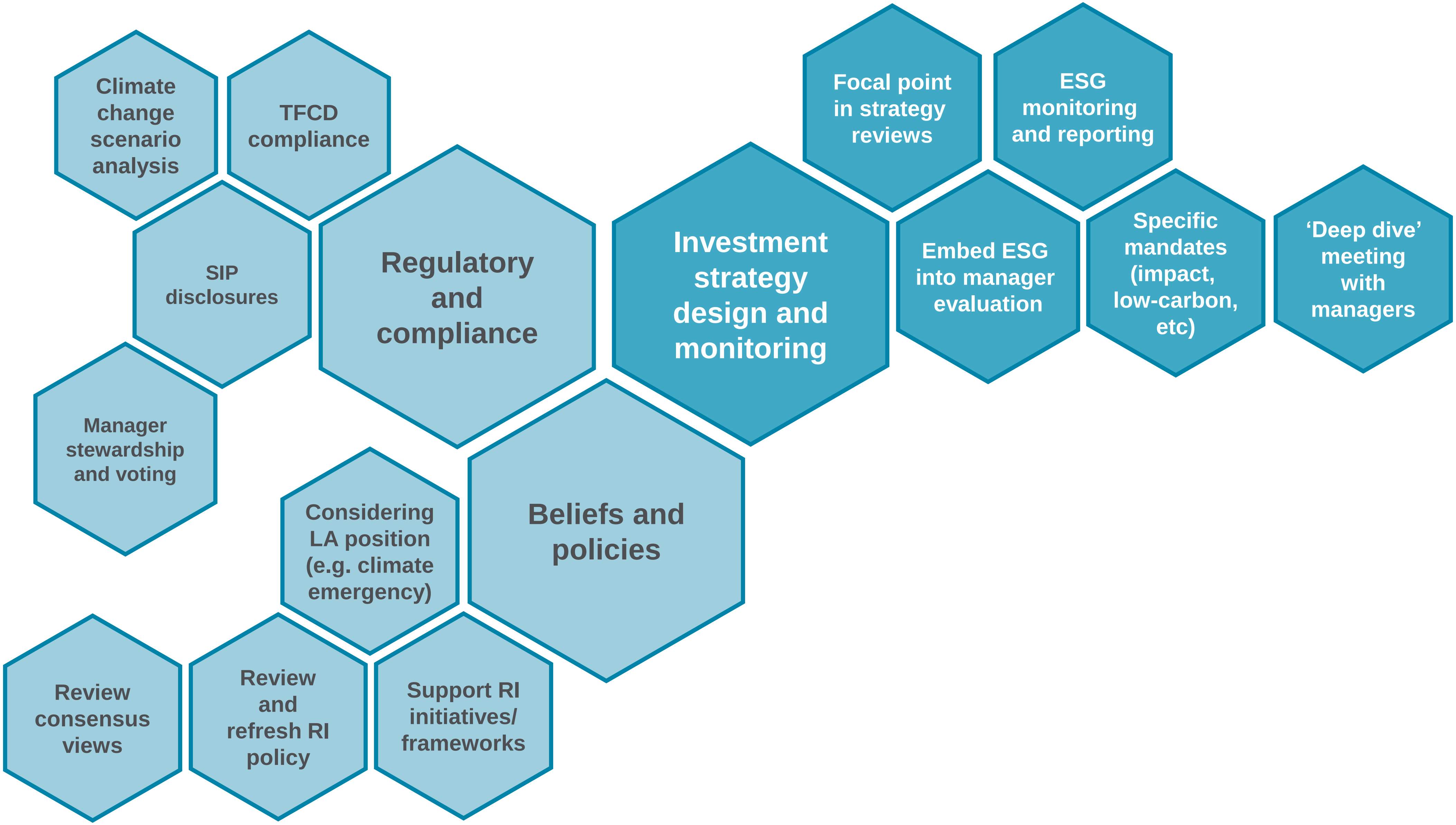
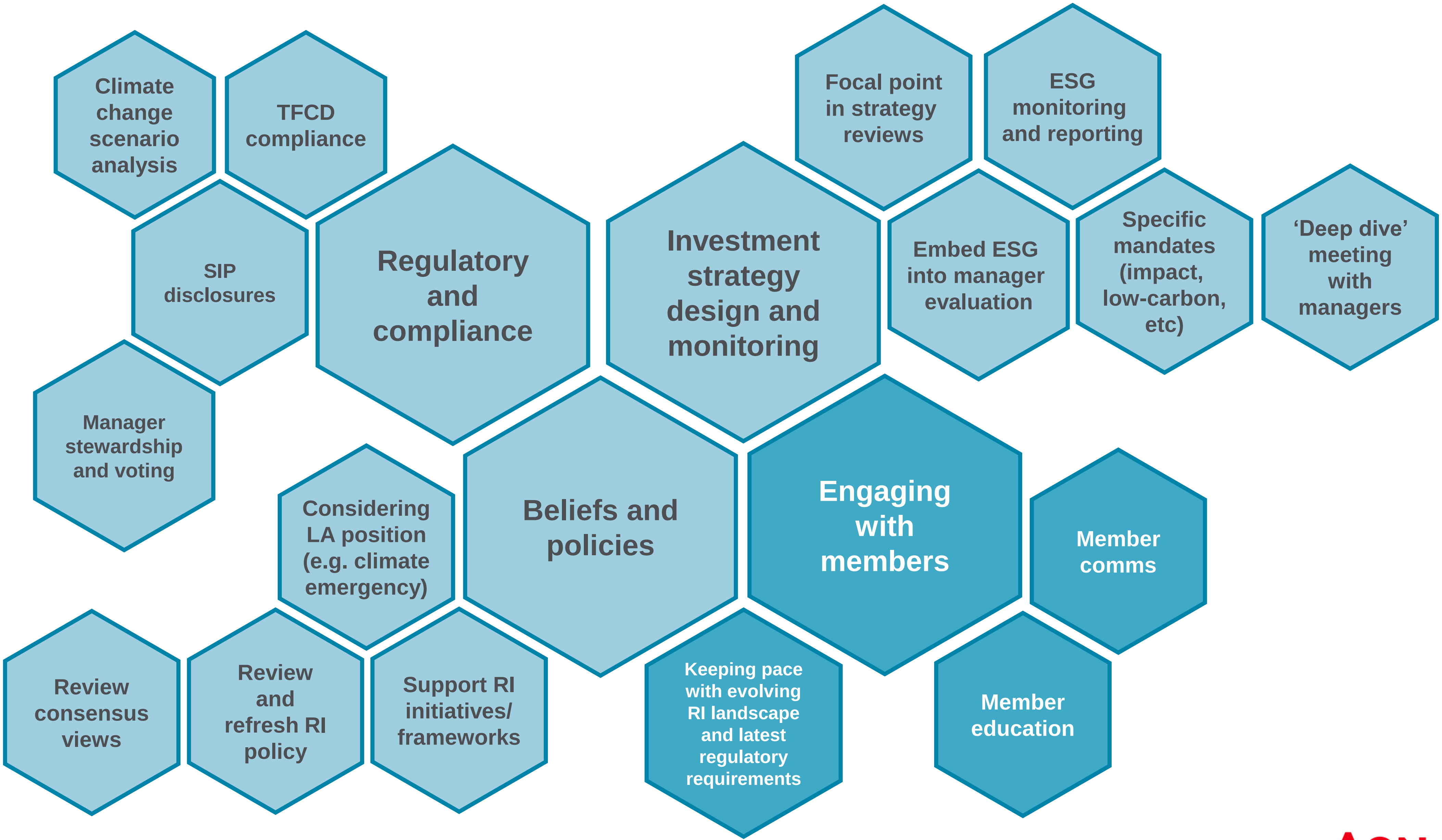


What other Funds are doing



What should you focus on?

Decarbonization

- Decarbonising the portfolio may be the absolute priority as soon as possible
- Starting this journey early will reduce the pressure towards the later years, as evident in the ambitious targets set for 2030 transition pathways

Drive the transition

- The path towards net zero is not linear.
- Traditional energy companies are some of the best placed firms to drive this change.
- Divesting and removing funding from these companies too quickly is considered by many counterproductive.
- Transition risk must also be considered, and the impact this could have on financial returns.

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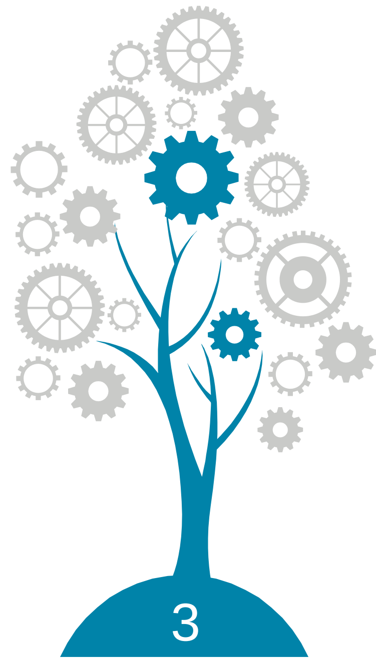
Seeing the wood for the trees…

Regular monitoring is key – but can be ‘noisy’.

We recommend an annual review versus targets.

Over time, the Fund’s data quality should improve.

Reassessing versus prior years will illustrate progress.



Reporting should be **quantitative and qualitative** in nature.

Qualitative reporting allows assessment of how effective engagement is, while quantitative reporting allows focus on reduction in carbon emissions.

Engagement, divestment and ‘greenwashing’

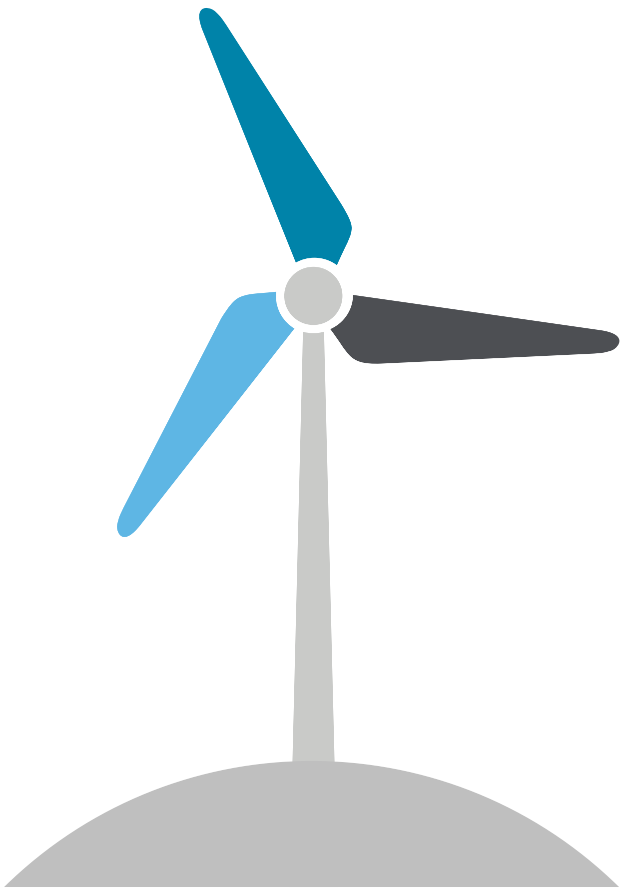
The divestment dilemma

Divestment means selling out of – and excluding future holdings – a certain area

- Our separate paper provides the Committee with more in-depth understanding of this.
- Often, divestment is focused on sectors such as fossil fuels.
- There are many motivations for divestment, such as:
  - Reducing carbon metrics for a portfolio
  - Addressing climate risk
  - Concerns over ‘stranded asset’ risks
- Whilst divestment may appear attractive, it is often not the biggest lever to pull.

Example

One LGPS conducted Trucost analysis to understand the impact of divesting from fossil fuels on their total portfolio, and discovered that this would **leave 87% of their total carbon emissions unaffected**.



Considerations

Thinking about climate risk should be holistic. This necessitates **engagement** to understand portfolio characteristics and advocate for thorough transition plans.

Engagement

“You can’t influence what you don’t own”

- Engagement is focused on the use of ownership stakes to influence behaviour and bring about positive changes.
- This is a core expectation on pension funds – that they will use their power of invested capital and be ‘active owners’
- Supporters of engagement-led approaches have criticised divestment for its inability to bring about meaningful action on climate change. This is primarily because the amounts divested generally account only for a small proportion of a targeted company’s value.
  - As there is generally a “seller for every buyer” the net result is that other (less climate-conscious) investors might benefit from the purchase and ownership of these assets in the near term
- Engagement with investee companies in a climate sense typically focuses on developing transition plans and transparency of disclosure so that investors understand their position.
- However, **divestment remains a lever if engagement is unsuccessful.**

Engagement in practice

Engagement activities can take up significant time and resource. Setting a plan of how these engagements would take place can ensure it is performed as efficiently and effectively as possible.

Possible actions to take

- **Inform** all existing managers/service providers in writing of the concerns regarding climate change risk management and any potential Net Zero or emissions targets. In this letter, set out clear expectations for the manager.
- Ask for **firm commitment** from the manager to achieve the goals that it has set.
- Create a **deep dive questionnaire** to be sent to managers on a regular basis (**annual or bi-annual**). This questionnaire should be used to monitor managers' progress towards their goals.
- The questionnaire should look for clear, concrete examples and evidence that these goals are in progress to avoid "greenwashing". This could include;
  - Carbon footprint and intensity metrics compared to the Fund's stated targets and milestones
  - Examples of engagements with underlying investments with regards to climate change, with clear rationale and outcomes
  - Any climate and sustainability-related memberships
- This level of engagement will require additional time, a clear governance structure with a climate risk sub-group could facilitate efficient delivery of such activity.

Objective

The objective of these engagements are to ensure the managers and service providers are aware of and working towards the same objectives as the Fund.

The Fund may wish to consider alternative investments if the engagements illustrate progress is not in line with expectations.

‘Greenwashing’: watch out!

‘Greenwashing’ is a form of ‘spin’ – portraying an investment as more environmentally friendly/sustainable than is really the case

- The Committee is likely to hear about greenwashing through news sources, and understanding these issues is directly relevant to the Fund’s approach to Responsible Investment.
- There have been several high profile fines levied on investment managers and companies as a result of greenwashing.
- In the investment process, due diligence of a manager’s ESG credentials is important to understand the robustness of their approach, as a safeguard. **Aon’s ESG ratings process interrogates this.**
- In public communications around the Fund’s target setting and Responsible Investment objectives, it is important that this is considered and the Fund is transparent and robust in its disclosures.

Aon’s approach to tackling greenwashing

- As part of our manager engagement we create a ‘buy list’ of managers who effectively integrate ESG risk factors and opportunities into their standard investment process. However, there are managers who do not deliver on their ESG related claims and fall short of our expectations for genuine ESG practices.
- We believe it is important to look at the good and the bad of ESG integration at all levels. As such, we have set out examples of our engagement with investment managers to identify and mitigate poor/deficient ESG practices in investment portfolios.
- We look to provide comfort that we engage on behalf of our clients to ensure their financial assets are invested in an impactful and appropriate way.

Case Studies

Following further analysis of an **ESG index** designed by a US index provider, it came to light that the single stock risks were underplayed during discussions with the index provider.

Why is this an issue? We viewed that the majority of performance will be driven by single stock exposure rather than association with the ESG theme, as clients may expect.

Outcome: This lead to the decline of further research on the ESG index due to inappropriate single stock risks.

Following further analysis and an initial call with the investment team of an **environmental solution provider**, it became evident that there were a significant number of stocks with questionable links to the environmental theme (banks, healthcare).

Why is this an issue? Subsequently, the fund has been rebranded to a broader ESG-anchored strategy rather than an environmental solutions product.

Outcome: The decline of further research on a thematic environmental equity strategy due to inappropriate thematic alignment marketed by a major European asset manager.

ESG transition was a theme regularly deployed to defend many laggards beyond a sensible level. We viewed the product development as cynical asset raising in the context of the boom in market-wide asset growth relative to other products offered by the manager.

Why is this an issue? ESG integration efforts were not robust to scrutiny during discussions with the investment team. Subsequently, asset growth in this strategy has been limited relative to peers.

Outcome: The decline of further research on a sustainable equity strategy marketed by a major Australian global manager.

Engagement Checklist

2023 Expectations

- Engage with managers to examine their ESG policies, and determine how they intend on approaching carbon reduction
- Continued Committee education

2024 Expectations

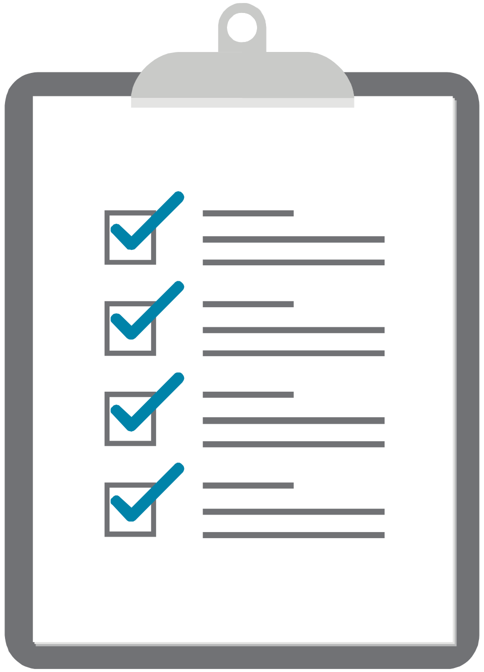
- Defined carbon reduction plan implemented
- Transparent carbon reporting
- Committee to consider consistency in carbon reporting from managers

2025/6 Expectations

- Reports of progress made towards carbon reduction target

Future Expectations

- Consider evolution of new low-carbon solutions available from managers as they develop
- Engage with the CIV to ensure low-carbon solutions are available.



Key takeaway

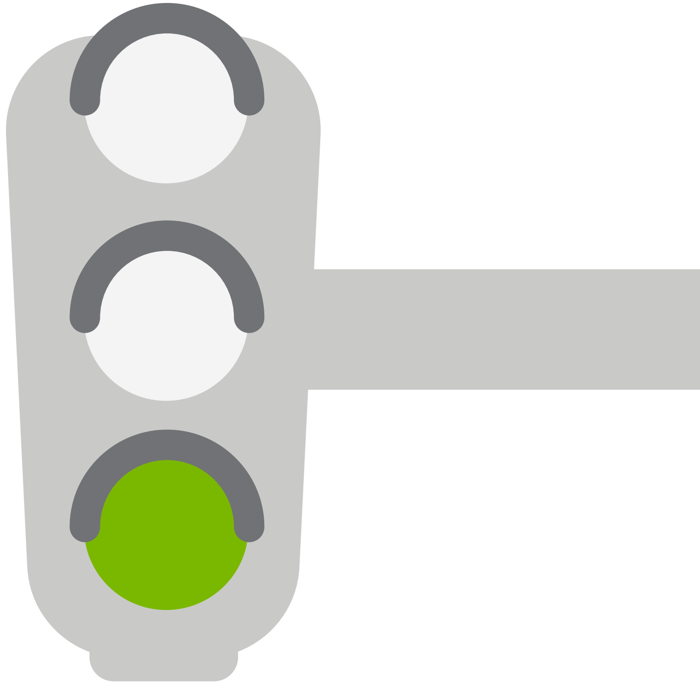
Aon can support with these steps.

A practical roadmap

Step 1: Prioritising priorities

There are many areas the Committee could focus on

- It will help to be clear about what objectives the Committee hope to achieve, so that a structured plan can be established to deliver this.
- Previously, the Committee have expressed a strong desire to focus on climate-related outcomes (e.g. aligning the Fund's portfolio with a net-zero trajectory) – but have also recognised that climate outcomes are closely linked with wider social and environmental issues.
  - The Committee could focus on climate action alongside selected wider social and environmental goals.
  - Understanding the ESG priorities of your current investments will help to determine how aligned they are with the Committee. **DECISION: Aon can provide a report on this for the Committee.**
- The Committee has also expressed an interest in the impact of its investment decisions on the wider world: how do the Fund's capital allocation choices influence wider outcomes?
  - The infrastructure discussion ongoing with the Committee is an example of this.
- If the Committee want to formally make progress against a net zero target, this will require concerted action. **DECISION: Agree in principle to commence this.**



Next steps

1 Engagement

Work directly with investment managers to ensure they are aligned. This could mean:

- Regular meetings with managers to understand and challenge investments and stewardship decisions
- Requesting managers to provide data, to review progress towards goals
- Setting expectations and escalation processes for when these are not met

2 Allocate

Away from “slow movers”; to “aligned”, low, zero or negative carbon assets, and offsets.

The Fund may wish to consider alternative investments if the current managers’ engagements illustrate progress is not in line with expectations.

3 Collaborate

What can we invest in to have a real world impact?

The Fund should collaborate with its investment managers to encourage the provision of data and information.

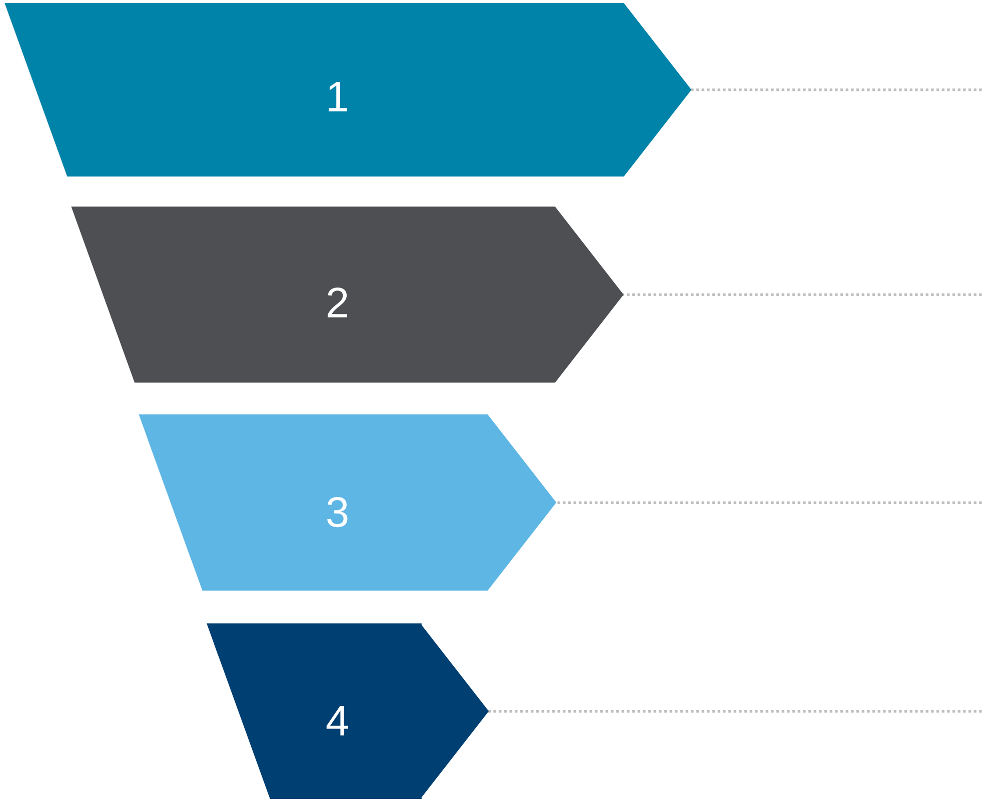
The Fund may wish to engage with industry initiatives to drive change.

Journey towards net zero is not straightforward

There are many ways to reduce the carbon footprint of investment portfolios, however, it is important to set a framework and milestones, and assess them regularly to monitor your journey towards the end goal.

Summary

Suggested Next Steps



Agreeing objectives

Previously, the Committee was highly focused on climate actions and implementing a comprehensive strategy. Reaffirming this is the ***'first next step'***.

Develop a plan

Having agreed on priorities and objectives, a plan should be developed to support the Fund achieving these outcomes.

Monitoring your profile

Understanding the Fund's 'ESG profile' can provide a valuable insight into, e.g., the climate footprint of your current investments.

Further training and workshops

This is a large area and will be under significant regulatory attention in the near term. Exploring this in more depth will help you develop your understanding further.

Key takeaway

To further develop the Fund's approach, we recommend devoting some time to do so thoughtfully.

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