



Glasgow City Council

Strathclyde Pension Fund Committee

Report by Director of Strathclyde Pension Fund

Contact: Richard McIndoe, Director

Item 4

2nd June 2021

Climate Change Strategy

Purpose of Report:

To present an update and proposed amendments to the Fund's Climate Change strategy.

Recommendations:

The Committee is asked **to AGREE** that:

- Strathclyde Pension Fund's Climate Change strategy should incorporate the explicit objective of implementing an investment strategy that is consistent with achieving the goal of global net-zero emissions by 2050; and therefore
- SPF should have a target of net-zero emissions across its own portfolios by 2050.
- The Fund should switch the current RAFI Global Allocation to the RAFI Fundamental Climate Transition Index when it becomes available

Ward No(s):

Citywide: ✓

Local member(s) advised: Yes ☐ No ☐ consulted: Yes ☐ No ☐

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1 Background

At its meeting in March 2020, the SPF committee considered a report regarding the approach by SPF to the management of climate change related risks and opportunities. The committee agreed to continue consideration of a number of recommendations, as detailed in the report, to enable a series of discussions/workshops to take place to consider the recommendations further, following which an updated report would be submitted for consideration. This report addresses the first of those recommendations, that within the context of its primary objective to pay pensions, SPF should have a clearly stated objective for its climate change strategy.

2 Climate Change Strategy

SPF's Climate Change Strategy is summarised in Appendix A. The summary follows the thematic approach set out by the Task Force on Climate-related Financial Disclosures (TCFD) – illustrated opposite.

Further information on the TCFD is included in Appendix B.



UK Government intends to consult on proposals to require all LGPS funds in England & Wales to comply with the TCFD requirements from 2022/23. There are no proposals regarding compliance by Scottish LGPS funds.

3 SPF and the TCFD Requirements

Strathclyde Pension Fund first complied with the TCFD requirements in 2019. A third iteration of disclosures will be included in SPF's 2020/21 Annual Report. This year's disclosures will include some enhancements and address some previous omissions. The first of these – scenario analysis – has already been completed as part of the 2020 actuarial valuation and review of investment strategy. A further omission is under Metrics and Target where the 2019/20 disclosure was that: the Fund is not currently using quantitative targets as part of its Climate change strategy but is considering a net-zero target.

4 Net Zero

In March 2021, the Institutional Investors Group on Climate Change (IIGCC), of which SPF is a member, launched a Net Zero Investment Framework as part of its Paris Aligned Investment Initiative. The primary objective of the framework is to ensure investors can decarbonise investment portfolios and increase investment in climate solutions, in a way that is consistent with a 1.5°C net zero emissions future. The IIGCC definition provides the following clarification: the Paris Aligned Investment Initiative Net Zero Investment Framework considers that "Paris aligned" investment means implementing an investment strategy that is consistent with achieving the goal of global net-zero emissions by 2050. It is proposed that SPF adopts this objective and reflects it in its 2021 TCFD disclosures.

5 Strategy Development

Having adopted this objective, SPF will need to develop its strategy to explicitly address achieving it. This might include the following:

- Intermediate Carbon Targets
- Changes to Portfolio Benchmarks
- Changes to Investment Mandates
- Changes to Portfolio Managers
- Consideration of the Sustainable Development Goals and
- Lower carbon Indexing.

Over the last year, SPF has progressed the last of those by reviewing alternatives to its current allocation to RAFI.

6 Alternatives to Current RAFI Allocation

6.1 RAFI

RAFI is an alternative approach to passive investment where allocation to stocks is based on value factors as opposed to market capitalisation. The Fund first invested in a RAFI strategy in 2013 and increased its exposure to the current level in 2015.

6.2 Alternatives

Since the RAFI strategy was adopted the market has evolved significantly, and a number of other factor based investment strategies are now available. Given the increased interest in climate change and responsible investment, some strategies now also target Environmental, Social and Governance (ESG) and sustainability factors.

A paper produced by Hymans Robertson as part of the recent review of SPF investment strategy outlined ways that the Fund could integrate responsible investment or climate factors into an index-based solution with L&G.

The value tilt of the RAFI allocation plays a key role in balancing overall style exposures across the Fund's equity mandates. When the committee agreed the initial recommendations from the investment strategy review, some further work was required:

- to ensure that any alternative strategy would meet the Fund's long term investment objectives alongside its wider approach to responsible investment and equity investing, and
- to consider which specific climate related factors or objectives such a strategy would seek to achieve.

6.3 Investment Advisory Panel

Hymans Robertson produced a further paper considering the points above, and the Investment Advisory Panel discussed this at its meeting on 13th May 2021. The Panel also received a presentation from L&G, who manage the RAFI allocation. L&G and Hymans Robertson outlined ways that the Fund could integrate climate factors by moving to one of 5 different index-based alternatives to the RAFI Global 3000 Fund. The Panel discussed all of the options available and agreed that the Fund should switch the current RAFI

Global Allocation to the RAFI Fundamental Climate Transition Index when it becomes available.

6.4 RAFI Fundamental Climate Transition Index

The RAFI Fundamental Climate Transition Index, due to launch later this year, will target a 30% reduction in carbon intensity at launch relative to market cap levels and a further 7% per annum thereafter. This index will also retain most of the value exposure that the Fund is seeking in order to balance style at an overall level. Further details of the construction of the index are set out in Appendix C.

6.5 RAFI Emerging Markets Fund

At present there are limited alternative options to achieve more meaningful decarbonisation in relation to the Fund's RAFI Emerging Markets Fund exposure. The Panel will discuss further at its August meeting.

7 Policy and Resource Implications

Resource

Implications:

<i>Financial:</i>	None at this time. The proposed change of RAFI index would incur some transition cost. This will be clarified once the index is finalised and will be minimised by the manager, L&G.
<i>Legal:</i>	None at this time.
<i>Personnel:</i>	None at this time.
<i>Procurement:</i>	None at this time.

Council Strategic Plan: Strathclyde Pension Fund aligns with the theme of a well governed city.

Equality and Socio-Economic Impacts:

<i>Does the proposal support the Council's Equality Outcomes 2017-22</i>	None at this time.
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<i>What are the potential equality impacts as a result of this report?</i>	None at this time.
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Please highlight if the policy/proposal will help address socio economic disadvantage.

Sustainability Impacts:

<i>Environmental:</i>	ESG (Environmental Social and Governance),
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Social, including opportunities under Article 20 of the European Public Procurement Directive:

and local impacts are addressed in the Fund's Responsible Investment strategy and Climate Change strategy.

Economic:

Privacy and Data

Protection impacts: None.

8 Recommendations

The Committee is asked **to AGREE** that:

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- SPF should have a target of net-zero emissions across its own portfolios by 2050.
- the Fund should switch the current RAFI Global Allocation to the RAFI Fundamental Climate Transition Index when it becomes available

Appendices

Appendix A

Appendix B

Appendix C

SPF Climate Change Strategy

Task Force on Climate-related Financial Disclosures

RAFI Fundamental Climate Transition Index

Summary of Climate Change Strategy

Strathclyde Pension Fund (SPF) believes that Climate Change is a systemic risk and thus a material long-term financial risk for any investor that must meet long-term obligations.

Control and mitigating actions listed against the risk from climate change include: SPF's climate change strategy, responsible investment strategy, diversification of investments, the Strathclyde Direct Investment Portfolio (DIP) and other positive investment opportunities.

Governance

- The Strathclyde Pension Fund Committee receives regular reports on the Fund's responsible investment activity including Climate Change.
- The Committee and officers are directly involved in analysis and decision making in respect of the Fund's Direct Investment Portfolio (DIP). To date, DIP has committed more than **£500m** to renewable energy infrastructure investments. SPF has also committed **£500m** to a global Infrastructure fund with a one third allocation to renewable energy assets.
- Day-to-day management of SPF's Climate Change strategy is delegated to the Fund's external investment managers.
- A bi-annual carbon footprinting exercise is used to assess both the risks from Climate Change and also areas of opportunity.
- SPF employs a specialist advisor, Sustainalytics, to focus engagement activity and to monitor voting activity on active equity holdings, with specific focus on Climate Change related resolutions.

Strategy

- SPF has a global investment strategy widely diversified by geography, asset class, sector and manager. Given the diversified nature of the Fund's strategy it will be exposed to all of the risks identified by the Task Force on Climate-Related Financial Disclosures (TCFD), though the degree and timing of the impact cannot be accurately gauged.
- SPF is primarily an equity investor, therefore the Fund's primary concern is that its equity investment managers and the management of the companies in which they invest have fully assessed climate –related risks and the potential impact on asset valuations, in particular from:
 - obsolescence, impairment or stranding of assets;
 - changing consumer demand patterns; and
 - changing cost structures including increased emissions pricing, insurance and investment in new technologies.
- SPF, and all of its investment managers, are signatories to the UN Principles for Responsible Investment (PRI).

Signatory of:



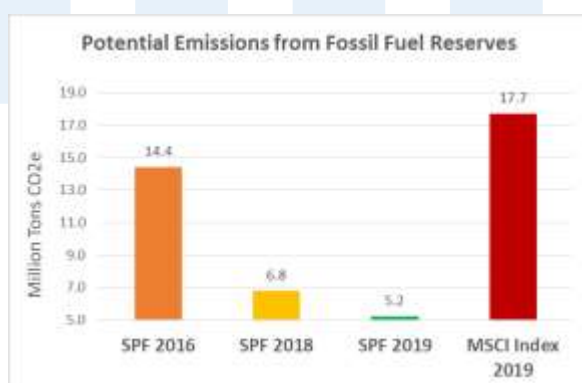
Risk Management

- External investment managers take into account any climate-related risks when making their investment decisions.
- SPF and Sustainalytics work with managers to ensure that these risks are being assessed and addressed. Carbon footprinting is used to inform this process.
- SPF also addresses these risks through its active participation in the Local Authority Pension Fund Forum (LAPFF), ShareAction, the Institutional Investor Group on Climate Change (IIGCC), Carbon Action, Climate Action 100+, and other ad hoc alliances.

Metrics and Targets

- SPF monitors the voting and engagement of all its Investment Managers on issues including Climate Change.
- SPF has engaged the leading carbon audit service provider, MSCI, to provide carbon and emissions footprinting.
- In 2018 the Fund's weighted average listed equity footprint was **192.5 tCO₂e/£ revenue**. This was **4.8%** lower than in 2016 and **6.2%** lower than that of the MSCI All Country World Index.
- The analysis further highlights that dominant sectors, in terms of emissions, tend to be Energy, Utilities, and Materials.
- The carbon footprinting analysis has considered the risk of 'Stranded Assets' in the Fund's listed equity by calculating the total potential emissions from fossil fuel reserves as tons of CO₂. In 2018 the total potential emissions from fossil fuel reserves was 23.7 million **tCO₂e**. This was **23.8%** lower than in 2016 and **23.7%** lower than that of the MSCI All Country World Index.
- The Fund is not currently using quantitative targets as part of its Climate Change strategy but is actively considering a net-zero target.

The chart below provides a year on year view of the Fund's ownership of potential emissions from all proven reserves of Thermal Coal, Oil and Gas owned by all the fossil fuel companies held in the Fund's active equity portfolio. Expressed as millions of tons of Co₂ and compared to an equal value of the most widely used global equity benchmark, the MSCI All Country World Index. The figures will be update during 2021.



Task Force on Climate-related Financial Disclosures (TCFD)**The Task Force's Remit**

In April 2015, the Group of 20 (G20) Finance Ministers and Central Bank Governors asked the Financial Stability Board to convene public- and private-sector participants to review how the financial sector can take account of climate-related issues. As part of its review, the FSB identified the need for better information to support informed investment, lending, and insurance underwriting decisions and improve understanding of climate related risks. To help identify the information needed to assess and price climate-related risks, the FSB established an industry-led task force — the TCFD. The FSB asked the TCFD to develop voluntary climate-related financial disclosures that would be useful to investors and others in understanding material risk

Extract from 2020 Status Report

Over the past 15 months, the number of organizations expressing support for the TCFD has grown more than 85%, reaching over 1,500 organizations globally, including over 1,340 companies with a market capitalization of \$12.6 trillion and financial institutions responsible for assets of \$150 trillion. Many of these companies have begun to implement the TCFD recommendations or continue to refine and improve their climate-related financial disclosures. Through the efforts of the World Business Council for Sustainable Development, the Institute for International Finance, the United Nations Environment Programme Finance Initiative, and other organizations, peer companies implementing the TCFD recommendations have come together to discuss effective climate-related financial disclosure practices and undertake work needed to enhance the effectiveness of such disclosures. Similar to the growth in the number of organizations supporting the TCFD, investor demand for companies to report information in line with the TCFD recommendations has also grown dramatically. For example, as part of Climate Action 100+, more than 500 investors with over \$47 trillion in assets under management are engaging the world's largest corporate greenhouse gas emitters to strengthen their climate-related disclosures by implementing the TCFD recommendations. In addition, many large asset managers and asset owners have asked or encouraged investee companies broadly to report in line with the TCFD recommendations and reflected this in their investment practices or policies. Over 110 regulators and governmental entities from around the world support the TCFD, including the governments of Belgium, Canada, Chile, France, Japan, New Zealand, Sweden, and the United Kingdom. In addition, central banks and supervisors from across the globe — through the Network for Greening the Financial System — have encouraged companies issuing public debt or equity to disclose in line with the TCFD recommendations. The Task Force is also seeing governments embed the recommendations in policy and guidance and move toward requiring TCFD disclosures through legislation and regulation.

RAFI Fundamental Climate Transition Index

Fundamental indexation

Fundamental indexation, where indices are created based on a number of potentially desirable stock characteristics rather than by the market capitalisation of the constituents, emerged as one of the first alternative indexation approaches.

Research Affiliates were an early mover in creating fundamental indices with their RAFI series.

Of the Fund's assets invested in passive LGIM funds, 75% is invested in traditional market-cap based passive funds. The remaining 25% is invested in fundamental indexation strategies invested in global and EM RAFI Fundamental index products (equivalent to 13% of the Fund's listed equity exposure). The Fund adopted the RAFI indices in 2013 and increased the allocation in 2015.

The starting universe for the FTSE RAFI indices is all listed stocks. This universe is then ranked or reconfigured such that the weighting of each company is determined by a fundamental measure or combination of measures. The RAFI indices use a liquidity screened universe of listed stocks and weight each constituent according to a combination of its share of the aggregate of the universe based on certain fundamental metrics (e.g. its sales as a proportion of total sales for the universe + its cash flow as a proportion of total cash flow for the universe etc).

RAFI uses the following accounting metrics in its methodology:

- Sales: total company sales averaged over the preceding 5 years
- Cash flow: total company cash flow averaged over the prior 5 years
- Book value: total company book value at the review date
- Dividend: total dividend distributions, averaged over the last 5 years

The fundamental weights are normalised in relation to their geographic regions and adjusted for the percentage of the company that is available to invest in on the public market (free-float). They are calculated annually with the rebalancing implementation spread over 4 quarters, and no stock can represent more than 10% of the index.

As noted in previous reviews, the nature of the metrics used within the RAFI index composition does tend to lead to a value bias.

RAFI Fundamental Climate Transition Index ('CTI')

This index offers exposure to the value factor while integrating objectives related to greenhouse gas emissions reductions and a transition to a low carbon economy. At launch the index will target a 30% reduction in carbon intensity relative to market cap levels, which is approximately a 45% reduction relative to the current RAFI Fundamental index. Going forward, carbon intensity will be reduced by a further 7% p.a.

Construction

The CTI is constructed by applying the factor methodology first and then applying tilts to achieve the climate integration, as follows:

- Starting with the RAFI Fundamental index
- Carbon intensity determined for each investee company. Carbon intensity is defined as carbon footprint/\$ company revenues (as discussed above) and only Scope 1 and 2 data is included in this analysis.
- Exclusions are then applied including stocks related to coal mining, tobacco, the production of controversial weapons and those that breach the UN Global

RAFI Fundamental Climate Transition Index

Compact. These are required to obtain stamps of approval, for example to comply with EU regulations for a Climate Transition Benchmark.

- The index is then tilted towards carbon efficient companies (at the expense of less efficient companies) until the target carbon intensity is achieved.
- Rebalancing still takes place on a quarterly basis.

This fund is still within the index creation stage and a launch date has yet to be confirmed. A draft index has been created and LGIM are in discussions with another LGPS fund about switching an existing RAFI Fundamental exposure over to the new CTI approach.