Roadmap – journey to net zero

This paper is addressed to the Pension Fund Sub-Committee and Officers of the London Borough of Brent Pension Fund ("the Fund") to breakdown the necessary steps for the Fund over the short, medium and long term in the context of setting and achieving its net-zero goals. The intended result is a living 'roadmap' that will evolve alongside the Fund's climate strategy.

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1. Introduction

Responsible investment, in particular climate risk, continues to dominate the LGPS and broader investment landscape. It is important for the Fund to evolve its investment strategy to take account of the opportunities and risks presented by climate change.

The Fund has made good progress to date in this regard with a number of important steps taken:

- Dedicated RI training sessions for Fund Officers and Sub-Committee members
- Introduction of RI focussed investment beliefs
- Investment in new low carbon mandate (BlackRock ACS World Low Carbon Equity Tracker)
- Updated Investment Strategy Statement (ISS) to reference carbon goals

It is now no longer best practice to simply consider broader ESG and climate risks within an investment strategy. The direction of travel from all sides (investment, regulatory and ethical) is to fully integrate RI, especially climate risk, into investment strategies in a manner consistent with achieving societal goals – minimising the risk of global temperatures increasing by more than 1.5 degrees, the target set by the Paris Agreement.

In our paper titled 'Positioning the Fund for the transition to a low carbon economy" dated June 2021 we covered at a high level the various considerations involved when setting a net-zero strategy including. These included important external factors, namely the Taskforce on Climate-Related Financial Disclosures (TCFD), the Institutional Investors Group on Climate Change (IIGCC) and the Stewardship Code. For convenience we have included a detailed summary of each in the appendix.

What the Fund is seeking to do now is build this into a detailed framework setting out the practical steps required over the short, medium and longer term to achieve its goal of net zero.

This paper therefore distils the various net zero aspects into a practical 'roadmap' for the Fund, starting with the key principles to be considered.

2. Background – RI focus and key principles

In establishing a net-zero roadmap, it is important to first be clear on what the main driver for change is as this will help provide focus and direction.

There exists a strong sense of responsibility amongst LGPS funds for using public sector finances to drive positive change. At the same time a fiduciary duty exists to deliver the best risk adjusted returns possible for members. In the past these may have been seen to be conflicting objectives but that is certainly no longer the case with the two very much intertwined as the world transitions to a low carbon economy.

As this transition takes place, there will be widescale reallocation of capital. Businesses and governments that manage climate risk effectively could be expected to out-perform those that don't. This will affect the returns and risks of their traded equities and bonds, a causal effect that can be assumed to extend to investments in general.

Positioning the Fund's strategy to play a part in this transition may therefore not just be for ethical reasons; it is likely to be aligned to the fiduciary duty of Officers and Sub-Committee members and so can be argued to be first and foremost an investment decision. It is investing with a view to generating higher returns than would otherwise be achieved.

Key principles

There are various themes/principles that will require due consideration by the Fund as part of the net-zero journey. Only once these areas have been addressed will appropriate implementation routes be able to be defined. For Brent, these are:

1. Effective stewardship

   This is arguably the most important aspect of being a responsible investor. There is a large school of thought supported by academic research that points to effective stewardship (e.g. voting, board representation) as being key drivers of positive performance, and perhaps even outperformance. There does need to be recognition though that driving positive change (e.g. decarbonisation) through engagement is a process that can take time.

   We understand the Council currently has a stated commitment in place to divest, but to do so in a responsible manner. A key focus for training is therefore to define what is meant by this commitment, whether it is something that the Fund would also be interested in adopting and if so how it would be implemented in practice. This will ultimately guide decisions the Fund will take on its net zero strategy over short, medium and long term.

2. Active management versus passive

   Secondly there is the age old active versus passive conundrum. Currently, the Fund's investment beliefs state:

   - *Passive management has a role to play in the Fund's structure; and*
   - *Active management can add value but it not guaranteed.*

   Ultimately the Fund recognise both styles have their place, with active management preferred for what are deemed to be less efficient markets e.g. emerging market equities, with passive funds the strategy of choice for developed market equities. As the range of investment funds further develops to meet the needs of investors seeking to reduce their carbon exposure, it's important to consider whether active or passive funds (or a combination of the two) will best meet the Fund's requirements. In addressing the Fund's net-zero goals, we feel this represents an opportune time for the Sub-Committee to also review their RI and broader investment beliefs.

3. Alignment with objectives and targets set by the Council and LCIV

   This relates to timeframes and alignment to relevant third parties. We are aware that the Council, the London Borough of Brent, has declared a 'climate emergency' and are committed to achieving net-zero by 2030. The London CIV (LCIV) on the other hand recently announced an intention to target 2040. Specifically, they state *in "recognising our duty to act in the long-term interests of our clients, it is recommended that the London CIV makes a commitment to become a Net-Zero company by 2040". As part of this they have also proposed interim carbon intensity targets for their fund range and broader engagement and transition targets. With LCIV effectively housing the Fund's assets, their sub-fund range and net-zero policy will undoubtedly be instrumental in facilitating and supporting the Fund's route to net zero. Any timeframe specified by the Fund will have a bearing on the actions and options included in the roadmap. For instance, should the Fund set a target date earlier than LCIV's own target, consideration will be needed as to what actions are required to accelerate carbon reduction versus the LCIV's transition pathway.*

3. Developing the 'framework'

In our paper titled 'Positioning the Fund for the transition to a low carbon economy" dated June 2021 we introduced the concept of a net-zero 'framework' in the form of 5 key areas or 'workstreams' central to setting and driving forward the Fund's strategy. Table 3.1 below summarises this framework along with a high level overview of the type of considerations that sit within each area.

Table 3.1: Net Zero Framework

Education	Understanding Net-zero, TCFD, IIGCC Understanding relevant metrics and key principles. Considering RI beliefs/priorities to steer implementation
Understanding the baseline	What is the current carbon and ESG position on the Fund? Understand any gaps that exist in data and what can be done to overcome these Understand the current trajectory of companies within the portfolio
Evaluating alignment and setting targets	Consider net-zero aspirations of relevant external parties Set short, medium and long term objectives and targets
Planning and implementation actions	Consider how best to manoeuvre strategy to be aligned to net-zero targets Are there elements to prioritise? Consider implementation routes in terms of consistency with beliefs
Monitoring and reporting progress	Consider ongoing monitoring regime Development of robust engagement policy

As with any LGPS investment strategy decision, the development of a net zero strategy should be done with a long term mindset. However, in formulating a 'roadmap' of targeted actions, it is necessary to look and plan over various timeframes. Achieving net-zero is not a one stop shop in terms of deciding on a course at time zero and sticking with it through to an end point. It will involve a concerted effort by all parties, with regular actions needing to be taken to stay on track. A robust plan must therefore factor this in by breaking down each area into the short, medium and long term. This can be seen by the proposed roadmap in the next section.

We see the actions taken over the next 12 months as being most helpful in defining the concrete plans. Inevitably the longer terms plans, e.g. for 2022 to 2024, will need to be refined as we monitor factors such as progress made by the Fund, its managers and LCIV, the availability of data plus any legislative changes. As such, the roadmap for 2022 to 2024 is framed more in terms of principles.

Roadmap

Short term (next 12-18 months)

Workstream	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023
Education	Training (5 October 2021 meeting) Begin review of RI beliefs/priorities (capturing ‘E’,’S’ & ‘G’)	Training (21 February 2022 meeting) Complete review of RI beliefs/priorities (capturing ‘E’,’S’ & ‘G’) Define stewardship role and monitoring requirements	Training - LCIV to provide overview of ESG funds	Training on TCFD/Stewardship Code		
Understanding the baseline	Carbon footprint/ESG reporting including gap analysis, e.g. for private market mandates	Agree carbon metrics to be monitored (e.g. WACI/total emissions/fossil fuel exposures) and form of regular reporting				
Evaluating alignment and setting targets	Officer engagement with LCIV regarding net zero target	Develop “strawman” based on 2030, 2040 and 2050 for illustration and to assess feasibility Initial discussions on targets	Agree initial targets, including qualitative targets for private markets if required Define “on track” target line			
Planning and implementation actions	Consider governance options to oversee implementation		Establish manager monitoring programme, e.g. attendance at meetings	Review structure of growth allocation following review of RI beliefs		Update relevant policies, e.g. ISS, RI beliefs
Monitoring and reporting progress	Engage with managers/LCIV on RI reporting format		Introduce carbon metric reporting in quarterly performance reporting			Review reporting – more detail at 31 March each year

Medium term (2-3 years)

	2022 to 2024
Education	Develop TCFD reporting, including sensitivity analysis, supported by training Re-affirm RI beliefs (2024)
Understanding the baseline	Review metrics being monitored, in light of availability of new data sources Assess portfolios on a more granular basis, e.g. proportions of investments classed as green/not green
Evaluating alignment and setting targets	Maintain regular dialogue with LCIV Review interim and long-term targets recognising progress made to date and external factors
Planning and implementation	Quantify impact of future strategy changes, e.g. wind down of CD, Alinda plus steps being taken by LCIV to reduce carbon emissions Is carbon reduction strategy on track versus targets line?
Monitoring and reporting	Annual carbon footprint/ESG reporting at 31 March Develop and submit TCFD reporting (deadline expected 2023)

5. Potential targets and initial list of funds to consider

We have set out below some potential targets for further consideration. The interim targets represent significant milestones towards the longer term net zero target.

- Net-zero aspiration: 2030 to 2050 (with a triennial review to gauge viability of bringing timeframe forward)
- Interim targets (those shown below are included as examples for discussion – actual targets will be agreed following discussions with Sub-Committee members and Officers):
    - Reduce carbon intensity as measured by Weighted Average Carbon Intensity (WACI) by X% by 2030 versus 2021 base year
    - Reduce total/potential emissions from fossil fuel reserves by X% by 2030 versus 2021 base year
    - Invest at least X% of Fund's portfolio in climate solutions (e.g. renewable infrastructure, green bonds, companies with >90% revenues from climate change activities) by 2030
    - Percentage of portfolio with net zero targets to be at least X% by 2030

Growth structure (developed market equities)

At 50% of the portfolio, the Fund's equity investments hold the key to achieving net-zero goals. Now, specific actions will result from analysis carried out as part of the growth structure review. However, we appreciate it will be helpful at this stage for Officers and Sub-Committee members to have an understanding of the direction of travel and therefore an insight into the types of actions that could be taken here. To this end we have outlined possible actions below that will be firmed up later in the year:

- Review rationale for continuing with 5% UK equity allocation (10% of overall equities). An outcome here could be to consolidate into global strategies to bring UK allocation into line with its share of global markets (5%).
- Following on from the above, actions can be taken to increase allocation to appropriate Paris aligned mandates (either active or passive depending on outcome of belief exercise) capable of achieving carbon reduction targets. A shortlist of options available to the Fund are shown below:
    - LCIV RBC Sustainable Equity Fund (active)
    - LCIV RBS Sustainable Equity Exclusion Fund (active)
    - LCIV Low Carbon Passive Equity Fund (to be launched)
    - LCIV Paris Aligned Active Equity Fund (to be launched)
    - BlackRock ACS World Low Carbon Equity Tracker Fund
    - LGIM Future World Range (a number of options within this)

  Summary details for each fund are shown in appendix D.

  Given the LCIV are now developing what can be deemed to be appropriate options for the Fund, due consideration will need to be given to any potential investments outside of the Pool.

6. Summary and next steps

As is evident from the roadmap, there is a significant amount of work involved in considering and setting a net-zero ambition for the Fund.

To progress with the Fund's net-zero agenda, we recommend the Sub-Committee agree the above roadmap in principle, with approval for any proposed changes delegated to Officers. This will allow Q4 2021 and Q1 2022 actions to be progressed ahead of the next Sub-Committee meeting in February 2022.

We look forward to discussing this with you.

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For and on behalf of Hymans Robertson LLP

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Appendix A: Taskforce for Climate-Related Financial Disclosures (TCFD)

The Task Force on Climate-Related Financial Disclosures (TCFD) established recommendations for disclosing clear, comparable and consistent information about the risks and opportunities presented by climate change. Their widespread adoption will ensure that the effects of climate change become routinely considered in business and investment decisions and will help better demonstrate responsibility and foresight in their consideration of climate issues, leading to smarter, more efficient allocation of capital, and helping to smooth the transition to a more sustainable, low carbon economy.

Currently there are no requirements for LGPS to report under TCFD, however, consultation on this is expected very soon with likely requirements coming in from 2022/23. For completeness, the recommended disclosures under TCFD are set out below:

Governance

a. Describe the board's oversight of climate-related risks and opportunities.
b. Describe management's role in assessing and managing climate elated risks and opportunities.

Strategy

a. Describe the climate-related risks and opportunities the organisation has identified over the short, medium, and long term.
b. Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning.
c. Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.

Risk Management

a. Describe the organisation's processes for identifying and assessing climate-related risks.
b. Describe the organisation's processes for managing climate-related risks.
c. Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.

Metrics and Target

a. Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process.
b. Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
c. Describe the targets used by the organisation to manage climate related risks and opportunities and performance against targets

Whilst there is no guarantee the LGPS requirements will be identical, there is no indication that they will be materially different, if at all. The Ministry for Housing, Communities and Local Government (MHCLG) recently stated earlier this year "A core principle we will be following is that the quality of the disclose and risk management should be as high for a LGPS fund as for their private sector counterpart," and that the consultation will be "very similar" to the Department for Work and Pensions' (DWP) proposals for private funds.

Given the planned adoption by the MHCLG for the LGPS within the medium term, it makes sense to start thinking about TCFD requirements and planning for their introduction. Aside from the mandatory aspect, the requirements can be considered to be best practice in the and advance planning can ensure a smooth, phased adoption, easing the governance burden on Officers and Sub-Committee members.

Appendix B: Institutional Investors Group on Climate Change (IGCC)

The institutional Investors Group on Climate Change (IIGCC) are a body for investor collaboration on climate change – their goal is to support the investment community in pursuing “significant and real” progress by 2030 towards a net zero future.

In doing so they have developed a Paris Aligned Investment Initiative (PAII) to assist investors in aligning their portfolios to the goals of the Paris Agreement, i.e. net zero by 2050. The main output so far has been their ‘Net Zero Investment Framework’ published earlier this year, March 2021.

Sets direction and portfolio structure for alignment

PORTFOLIO / FUND LEVEL

4 Governance and Strategy

- ☐ Commit to the goal of achieving net zero portfolio emissions by 2050, or sooner, and adopt an investment strategy consistent with the achievement of global net zero emissions by this date
- ☐ Define beliefs, set investment strategy and mandates/performance objectives for portfolio managers, asset managers, and other relevant personnel
- ☐ Undertake climate financial risk assessment in line with TCFD recommendations
- ☐ Publish a clear action plan, and disclose information on governance, strategy, metrics and targets, and management in relation to achieving alignment to net zero

5 Targets and Objectives

- ☐ Set medium term emissions reduction and climate solutions reference targets to inform SAA and monitor impact of strategy

6 Strategic Asset Allocation

- ☐ Update capital market assumptions based on scenario analysis
- ☐ Optimisation with emissions and climate solutions metrics
- ☐ Set asset class mix with climate variants
- ☐ Review constraints to increasing alignment

Shifts alignment of assets to meet portfolio goals

ASSET CLASS LEVEL

7 Asset Class Alignment

Assess assets and set targets:

- ☐ Assess assets based on current and forward looking alignment criteria, and investment in climate solutions
- ☐ Set goals for increasing % AUM invested in aligned assets
- ☐ Implement an engagement goal to ensure at least 70% of financed emissions in material sectors are either net zero, aligned to a net zero pathway, or the subject of direct or collective engagement and stewardship actions

Implement:

- ☐ Portfolio construction: Screening, positive and negative weighting, tilted benchmarks to allocate capital to support alignment and invest in climate solutions
- ☐ Engagement: Criteria based escalating engagement and voting strategy for non-aligned assets; tenant and issuer engagement
- ☐ Selective divestment: Based on climate-related financial risk; engagement escalation; non-permissible activity thresholds
- ☐ Investment/management actions for directly owned assets (e.g. real estate)

Influences enabling environment to facilitate alignment

EXTERNAL

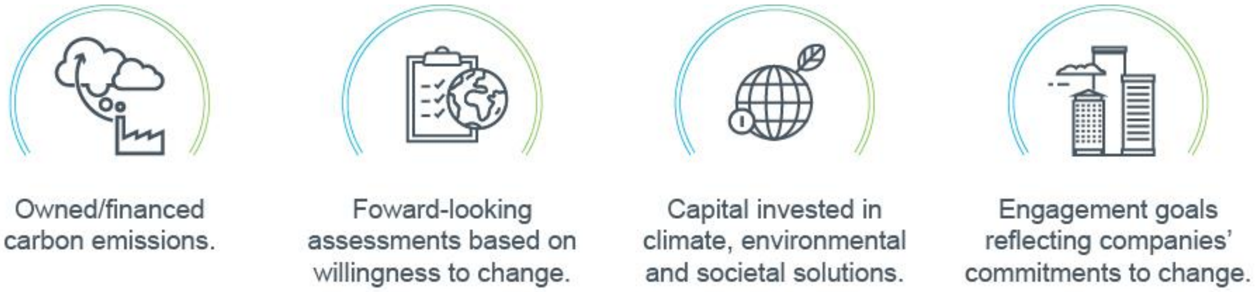
8 Policy Advocacy

- ☐ Net zero aligned policy and regulation
- ☐ Disclosure; shareholder rights
- ☐ Collective and direct advocacy delivered through meetings, letters, responding to consultations, and media activity, as well as ensuring trade association advocacy is consistent with net zero goals

8 Market Engagement

- ☐ Asset manager or client
- ☐ Market actors including credit rating agencies, auditors, stock exchanges, proxy advisers, investment consultants, and data and service providers

In setting objectives, the IIGCC framework proposes both high level (portfolio level) and more granular (asset level) targets and objectives are set. The framework also suggests that any objectives should be set with no more than a 5-10 year time horizon in order that action can be focused. Suggested areas of coverage under the framework are:



Appendix C: Stewardship Code

In 2010, the Financial Reporting Council (FRC) published its first version of the UK Stewardship Code. In 2019, the FRC released an update version – the UK Stewardship Code 2020. As per the original, the goal of the Code is to “enhance the quality of engagement between investors and companies to help improve long-term risk-adjusted returns to shareholders”. The code aims to achieve this by setting high stewardship standards for asset owners and asset managers, and also for service providers where applicable.

It is a voluntary code that adopts an ‘apply and explain’ principles approach. There are 12 principles covering the following:

1. Purpose, strategy and culture
2. Governance, resources and incentives
3. Conflicts of interest
4. Promoting well-functioning markets
5. Review and assurance
6. Client and beneficiary needs
7. Stewardship, investment and ESG integration
8. Monitoring managers and service providers
9. Engagement
10. Collaboration
11. Escalation
12. Exercising rights and responsibilities