Leicestershire County Council

LOCAL PENSION COMMITTEE – 18 NOVEMBER 2022

DIRECTOR OF CORPORATE RESORUCES

CLIMATE RISK REPORT 2022

Purpose of the Report

1. The purpose of this report is to provide the Local Pension Committee with background information on the Leicestershire Pension Funds (Fund) 2022 Climate Risk Report (CRR) and Climate Scenario Analysis. A PowerPoint presentation will be delivered at the meeting by representatives from LGPS Central, a copy of the Leicestershire County Council Climate Risk Report is attached as the appendix to the report.

Background

2. The Fund has produced a Climate Risk Report annually since 2020. Through a combination of bottom-up and top-down analysis, the report was designed to give the Fund a view of the climate risk held throughout its entire asset portfolio, accompanied by proposed actions the Fund could take to manage and reduce that risk. This allows the fund to analyse progress against the baseline of data from previous reports, reassess the Fund's exposure to climate-related risks and opportunities, and identify further means for the Fund to manage its material risks.

3. The report includes the Fund's second climate scenario analysis which estimates the effects on key financial parameters (such as risk and return) that could result from plausible climate scenarios. In these reports the scenarios are defined according to the change since pre-industrial times in mean global surface temperatures, and consider three scenarios (rapid, orderly and failed transitions which result in implied temperature increase of 1.5°C, 1.6°C and 4°C by 2100 respectively) across three timescales (5, 15 and 40 years).

4. A climate stewardship plan was further delivered in 2021 and included a list of companies the Fund has exposure to. The companies included within the plan are those which face a high level of climate risk and are of particular significance to the Fund's portfolio. Most of these companies are captured by the Climate Action 100+ (CA100+) engagement project, in which the Fund's pooling company LGPS Central is an active participant.

Climate Risk Report (CRR) 2022

5. A copy of Leicestershire Pension Fund's CRR is attached as the appendix to the report. LGPS Central will deliver a PowerPoint presentation to cover the key points in the report at the meeting.

6. The CRR report is structured to align with the four pillars of the Taskforce on Climate-Related Financial Disclosures (TCFD) and facilitates public disclosure against this framework: Governance, Strategy, Risk Management and Metrics and Targets.

7. The Strategy has been shared with the Fund's Investment Advisor and will be taken into account as part of the Fund's Strategic Asset Allocation and has been used in development of the draft Net Zero Climate Strategy, which will be considered elsewhere on today's agenda.

8. Key highlights from the CRR report are summarised below:

- The carbon Intensity of the Fund, which refers to the Scope 1 and 2 emissions divided by $million sales for each portfolio companies, has decreased by 26.45% as of March 2022, from December 2019 levels. The carbon intensity of total equities is now 18.82% lower than the benchmark.

- Financed emissions of the Fund's equity portfolio, which refers to the metric used to estimate the proportion of emissions an investment has financed, has decreased by 20.14% from December 2019 to March 2022.

- Decreases in the carbon intensity and financed emissions have been driven by the switch from FTSE RAFI All World 3000 Developed Europe Ex UK Equity Index and North America Equity Index to the LGPS Central Climate Multi Factor Fund.

- 62.5% of companies in the Climate Stewardship Plan have achieved a Transition Pathway Initiative[1] Management Quality rating of 4 or 4*. These are the highest ratings awarded by TPI, implying that the company has developed a strategic and holistic understanding of the risks and opportunities related to the low-carbon transition.

Governance

9. LGPS Central reviewed the Fund's published documentation and governance arrangements from the perspective of climate strategy setting. Central identified areas in which the Fund's governance and policies could further embed and normalise the management of climate risk.

10. The Fund has made considerable progress in terms of its responsible investment and climate change practice. Since 2021, the Fund has published its first TCFD aligned report which was then included in the Pension Fund Annual report. The Fund has also approved annual responsible investment plan and successfully integrated key Environmental, Social and Governance themes into the 2022 investment strategy. Central further recognise the steps to produce the Fund's first Net Zero Climate Strategy.

[1] The Transition Pathway Initiative (TPI) framework evaluates companies based on their climate risk management quality and their carbon performance.

11. Central believe that the Fund's existing climate governance is already to a high standard, and recommendations and considerations offered are suggestive only. These are set out at the end of this report alongside officer comments.

<u>Strategy: Climate Scenario Analysis</u>

12. The Fund first produced a Climate Scenario Analysis in 2020, using the services of Mercer LLC. Climate Scenario Analysis estimates the effects on key financial parameters (such as risk and return) that could result from plausible climate scenarios. In these reports the scenarios are defined according to the change since pre-industrial times in mean global surface temperatures. Mercer's climate scenarios are constructed to explore three climate scenarios (Rapid Transition, Orderly Transition and Failed Transition) are constructed to explore a range of plausible futures over 5 to 40 years, rather than exploring tail risks. Mercer's analysis considers two risk factors:

- Transition Risk – Technological and Policy related
- Physical Risk – Availability of natural resources, chronic damages, and acute damages relating to natural disasters and increased temperature rises.

13. Although the predictions made by climate scientists have gained overwhelming consensus, there remains a great deal of uncertainty for investors around the market reaction to climate risks and changing climate policies. This creates a strong argument for Climate Scenario Analysis to understand the different possible eventualities across a range of scenarios. It is important that investors assess their portfolio's resilience to different climate scenarios and consider the impact of their portfolios on future climate trajectories.

14. The analysis included the whole of the Pension Fund's portfolio (as of 31 March 2022), as well as a variant of the portfolio if the Fund was fully aligned to its target strategic asset allocation. The projections assume £5.8 billion initial asset value and contributions income matches benefit outgoings.

15. In summary the main points that arose from the analysis are as follows:

    i. A successful transition is an imperative: Over the medium and long term the Fund's current asset allocation performs better under a rapid and orderly transition scenario, versus a failed transition. A failed transition could result in cumulative losses circa 32% of the portfolio's value relative to the baseline.

    ii. Growth assets are generally more exposed to transition and physical risks: Increased allocations to sustainable equity would provide additional protection from transition and physical risks in the event of a rapid transition

    iii. It's important to monitor sector and regional exposure. The differences in return impact are most visible at an industry sector level, with significant divergence between scenarios. Oil and Gas, Fossil Fuel Based Utilities and Renewables are most impacted by the transition.

    iv. The Fund must be aware of future pricing shocks. As markets react to new information because of changing physical and policy transition risks, investors may be vulnerable to rapid repricing shocks.

16. Central is clear in their commentary that they remain conscious that scenario analysis (of any kind) requires by necessity the use of assumptions about inherently unpredictable phenomena. This analysis is no different in this regard. Central believe however that investors looking to manage climate risk proactively ought to attempt an 'inference to the best explanation' and think that Mercer's model and approach to Climate Scenario Analysis is the best available.

17. Recommendations and considerations from Central are included at the end of this report alongside officer comments.

Risk Management: Climate Stewardship Plan

18. The Fund has developed a Climate Stewardship Plan which is included within the CRR. The Plan identifies the areas in which stewardship techniques can be leveraged to further understand and manage climate-related risks within the Fund.

19. The Plan identifies a focus list of eight companies for prioritised engagement reflecting the externally managed nature of the Fund. The Fund's portfolio managers and suppliers are engaging with these companies on behalf of the Fund. Appendix A includes further detail on progress of ongoing engagements overtime, given the long-term nature of responsible stewardship. These stewardship activities relate to companies within various sectors such as mining, materials, cement, utilities, energy and information technology.

20. Progress is evident when comparing Climate Action 100+ Net Zero Benchmark (NZB) scores for companies in the Plan from 2021 to 2022. Of the NZB indicators Stewardship Plan companies are measured against, the number of indicators which achieved all criteria required doubled from 7 to 14, as a result indicators which only met some criteria decreased by 8.8%. The number of criteria which was not met decreased by 18.2%.

21. The NZB is important as it assesses the world's largest corporate greenhouse gas emitters on their net zero transition. Covering 165 focus companies that account for up to 80% of global corporate industrial greenhouse gas emissions.

22. Furthermore 62.5% of companies in the Climate Stewardship Plan achieve a Transition Pathway Initiative (TPI) Management Quality Rating of 4 or 4*.

23. The TPI Management Quality rating of 4 or 4* represents the highest ratings awarded by TPI, implying that the company has developed a strategic and holistic understanding of the risks and opportunities related to the low-carbon transition.

24. Currently, none of the companies within the Stewardship Plan have attained all the indicators within the CA100+ benchmark assessment, and only two companies (Cemex and Holcim) are aligned with a 1.5°C scenario by 2050. However, most of the companies are making clear progress in their climate strategies, which is evidenced through several measures of success that is set out within Appendix A.

25. The Fund will continue to work with its partners to achieve objectives set out within the Plan to increase achievement of the high-level objectives of the CA100+ Initiative, and for companies to account for climate risks in financial reporting.

26. Recommendations and considerations from Central are included at the end of this report alongside officer comments.

Metrics and Targets

27. The Carbon Risk Metrics section is a bottom-up analysis conducted at the company and portfolio level. The purposes of this analysis are:

- To observe climate transition risks and opportunities in the portfolio
- To identify company engagement opportunities
- To support investment manager monitoring of climate risk management

28. Carbon metrics with respect to the portfolio on 31st March 2022 are disclosed alongside the Fund's first CRR metrics which were calculated on the portfolio as of 31st December 2019. The 2022 analysis covers over 4618 companies within the equity portfolio. A summary is shown below:

- The total equities carbon intensity decreased by 26.45% between 2019 and 2022 for total equities.

- The financed emissions of total equities decreased by 20.14% between 2019 and 2022.

- Overall, when compared to the benchmarks carbon metrics the Fund is circa 18% more carbon efficient at total equity level.

29. Reductions are primarily driven by passive equity due to the transition to the LGPS Central Climate Multi Factor Fund, whereas active equity saw an increase in financed emissions by 11.29%. This increase in financed emissions can be associated with the selection of companies within the materials sector and increased exposure to the energy sector in the two multi manager funds.

30. The Fund has spoken to Central about this increase and have been assured that the underlying investment managers consider climate risk in their decision making. Central also has communicated its expectations to the managers relating to climate performance and net zero ambition.

31. The report also measures the Fund's weight to fossil fuel reserves and weight in clean technology versus the benchmarks for each of the mandates. This year's report includes further metrics to expand the understanding the Fund has of its exposure to climate risk and opportunities.

32. For exposure to fossil fuel reserves both total active and total passive equity funds experienced a decrease in exposure to all three aspects between 2019 to 2022. Most notably, the passive equity funds decreased exposure to fossil fuel reserves by 2.26%, while active equity funds decreased exposure by 0.49%. resulting in a decrease of 1.78% in total equities exposure.

Table 1Total Equities Fund Fossil Fuel Metrics

	2019	2022	% Difference Between 2019 and 2022
Weight in fossil fuel reserves	8.57%	6.79%	-1.78%
By Revenue		1.00%	
Weight in thermal coal reserves	2.87%	2.50%	-0.37%
By Revenue		0.05%	
Weight in coal power (%)	1.40%	1.15%	-0.25%

33. Weight in fossil fuel reserves: The weight of the Fund invested in companies that
    (i) own fossil fuel reserves
    (ii) thermal coal reserves
    (iii) utilities deriving more than 30% of their energy mix from coal power.

34. This metric does not consider the amount of revenue a company generates from fossil fuel activities. Consequently, diversified businesses (for example, those that own a range of underlying companies, one of which owns reserves) would be included when calculating this metric. In reality these companies may not bear as much stranded asset risk as companies that do generate a high proportion of revenue from fossil fuels.

35. New to this year's report is exposure by revenue: This identifies the maximum percentage of revenue either reported or estimated derived from conventional oil and gas, unconventional oil and gas, as well as thermal coal. These values by companies are summed and weighted by the portfolio weights to produce a weighted exposure. This metric has been included to overcome the limitations of the first metric which includes all companies which have any exposure regardless of how small. This measurement uses maximised estimates where reported values are not available. Therefore, there is a potential to overestimate exposure.

36. In relation to total equities, exposure to clean technology (companies whose products and services include Alternative Energy, Energy Efficiency, Green Buildings, Pollution Prevention, and Sustainable Water) has increased by 4.08% between 2019 and 2022. Although 38.24% of total equities is invested in companies with clean technology exposure, only 4.21% of the total revenue generated by portfolio companies is derived from clean technology solutions (as defined by MSCI) suggesting the majority of companies are not pure-play clean technology companies (i.e. they do not derive a significant proportion of their revenue from clean tech).

Table 2 Total Equities Fund Clean Technology Metrics

	2019	2022	% Difference Between 2019 and 2022
Weight in Clean Technology	34.16%	38.24%	4.08%
By Revenue		4.21%	

37. While MSCI has been used for this report due to its wide range of listed companies and data points, there is no universal standard or definitive list of green revenues. This is due to the inherent difficulty in compiling a complete and exhaustive list of technologies relevant for a lower-carbon economy. As with fossil fuel exposure, this

table includes a new metric to measure by revenue, this features the same pros and limitations as previously discussed.

38. Looking at companies generally within total equities of the 404 companies that have been assessed and ranked by the Transition Pathway Initiative, about half of these assessed companies (50.96%) of the companies assessed achieved a management quality rating of 4-4*.

39. Furthermore, just under half (47.22%) of the companies within equity funds are committed to achieving Net Zero emissions by 2050. 62.48% of the portfolio's financed emissions are generated by companies which have set Net Zero targets. Whilst this does suggest commitments are being made by the right companies, there are still a significant proportion yet to set a Net Zero Target, thus emphasising the need for engagement within this next critical decade.

40. The Fund will work with Central to shape its future stewardship activities in line with these findings. As well as aim to include a greater proportion of the Fund's assets when calculating future climate metrics. At present investments such as infrastructure, property and credit assets do not have climate metrics. There are growing efforts to include more asset classes throughout the industry. Increasing the percentage of assets covered will be a significant step to fully understanding and managing climate risk.

Recommendations and Considerations of the Climate Risk Report

41. The report includes updates on the 2021 CRR governance recommendations. The remaining recommendations will be included in the updated Responsible Investment Plan that will be presented to the Local Pension Committee in January 2023.

42. The report makes a number of recommendations for the coming year. These are shown below with a comment from Fund officers where applicable. A number of recommendations were successfully achieved in 2021, but due to their ongoing nature it is recommended they continue as regular practice.

Category	Recommended Actions and Considerations proposed by LGPS Central	Fund Comment
Governance	Continue to report decarbonisation progress on annual basis.	Reported annually.
	Annual training session on RI matters and climate specific training.	Included as part of RI Plan.
	Approval of Net Zero Climate Strategy (NZCS)	Ongoing.
	Continue to schedule time for discussion of climate related risks and opportunities.	Included as part of RI Plan.
	Integrate communications on climate risk into Communication Strategy.	To be implemented alongside Admin and Communication Strategy review.
	Make clear the roles of key governance committees in the ISS.	Under review elsewhere on

		today's agenda.
Strategy	Continue with actions which are positively correlated with broader Net Zero strategies through its various collaborations.	To be set out in NZCS
	Continue to work with LGPS and external managers regarding the NZCS	Ongoing.
	Consider reducing portfolio weighting of growth assets and increasing weighting to sustainable equity to mitigate potential transition impact.	To be considered with Investment Advisor.
	Work with appointed fund managers to understand how they are assessing, monitoring and mitigating key transition and physical risks.	To be included as part of 2023 RI Plan.
	Using the analysis from this Climate Scenario Analysis and the overall Climate Risk Report to evolve LPF's sustainable investment targets to include more ambitious climate objectives.	Used in preparation of NZCS.
Risk Management	Continue to engage the companies highlighted in the Climate Stewardship plan through selected stewardship partners.	Ongoing.
	Consider adding **Linde PLC** to the Climate Stewardship Plan, as it is now the second highest contributor to the carbon intensity of the portfolio.	Supported.
	Report progress in the next Climate Risk Report.	Reported annually.
Metrics and Targets	Continue to monitor the carbon intensity and financed emissions of this portfolio, and companies as part of the Climate Stewardship Plan. Continue to monitor key carbon intensive firms to the Fund's Climate Stewardship Plan. Consider adding other carbon intensive firms to the Climate Stewardship Plan which are not yet included.	Reported annually Under review.

<u>Supplementary Information</u>

43. An exempt paper is included elsewhere on the agenda which includes information regarding the underlying mandate climate metrics which cannot be included for public consideration due to the contract between the data provider and LGPS Central.

<u>Recommendation</u>

It is recommended that:

a) The Climate Risk Report be noted.
b) That the recommended actions and considerations set out in paragraph 42 be approved for inclusion within the Fund's Responsible Investment Plan 2023.

Equality and Human Rights Implications

44. None.

Appendix

Climate Risk Report 2022

Background Papers

None

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