



LOCAL PENSION BOARD – 8 FEBRUARY 2023
REPORT OF THE DIRECTOR OF CORPORATE RESOURCES
DEVELOPMENT OF THE NET ZERO CLIMATE STRATEGY

Purpose of the Report

1. The purpose of this report is to inform the Local Pension Board of the development of the Net Zero Climate Strategy and feedback received during the first public engagement on draft targets and measures.
2. The report provides the Local Pension Board with the opportunity to comment on the draft Net Zero Climate Strategy.

Policy Framework and Previous Decisions

3. The Fund must follow the law and statutory guidance for preparing and maintaining its Investment Strategy Statement and must take proper advice and act prudently when making investment decisions. Subject to this, the Fund should consider any factors that are financially material to the performance of its investments, including environmental, social and governance (ESG) factors. This includes considerations over the long term, dependent on the time horizon over which the Fund's liabilities arise.
4. The appetite of the Fund for taking risk when making investment decisions is ultimately for local consideration and determination by the Local Pensions Committee subject to the aim and purpose of the Fund, to maximise investment returns within reasonable risk parameters. It is not the role of the Fund to put non-financial beliefs, such as ethical or moral considerations above those of the employers funding the pension scheme.
5. Responsible Investment is an approach to investment that aims to incorporate environmental (including climate change), social and governance factors into investment decisions, to better manage risk and generate sustainable investment returns, as set out in the Fund's Investment Strategy Statement.
6. The Local Pension Committee approves an annual Responsible Investment (RI) plan, the latest of which was approved in January 2023 and supports the above approach, with a continual focus on raising RI standards.

7. In November 2021 the Local Pension Committee agreed to commence work on producing the Fund's first Climate Strategy, recognising the systematic impact climate change could have on the Fund. In June 2022 it was agreed to engage on proposed metrics that were in line with the Net Zero Investment Framework developed by the Institutional Investors Group on Climate Change, a group with over 375 investor members with more than £45trillion in assets.

Background

8. As set out in the Fund's Investment Strategy Statement the Fund holds investments in various asset classes, which includes the world's biggest companies in sectors that include manufacturing, technology, and transport. Climate change is a systematic risk where the climate actions, or inaction, of companies can positively or negatively affect other companies, as well as the overall economy.
9. In recognition of the risk climate change poses the Fund has produced a Climate Risk Report annually since 2020. This report combines bottom-up and top-down analysis and is 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 enables 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.
10. Since the Fund's benchmark as of 31 December 2019, the Fund has shown clear progress as of 31 March 2022, which includes:
 - The carbon intensity of the Fund reduced by 26% across measurable investments.
 - The Fund's exposure to companies that own fossil fuel reserves reduced from 8.57% to 6.79% of listed equity assets.
 - Increased investment in companies whose products and services include clean technology (including alternative energy, green buildings, pollution prevention and sustainable water) from 34.16% to 38.24% within listed equity assets.
11. The Fund also recently produced its second Climate Scenario Analysis, via the services of Mercer LLC. The Climate Scenario Analysis estimates the effects on key financial parameters (such as risk and return) that could result from plausible climate scenarios. This considers transition risk and physical risk, over a range of plausible futures over 5 to 40 years under three scenarios, rapid transition, orderly transition and failed transition. Assessing

the Fund's resilience to different climate scenarios and consider the impact of their portfolios on future climate trajectories.

12. The latest analysis undertaken on the Fund's asset allocation as at March 2022 predicts the Fund's returns are best protected in an orderly or rapid transition, in comparison to a failed transition, which could result in cumulative losses around 32% of the portfolio's value relative to the baseline. For the Fund it is clear over the medium to long term a successful transition is imperative, which it intends to support through the development of the Net Zero Climate Strategy.

Results of Engagement

13. The Local Pension Committee, at its meeting on 10 June 2022, approved a public engagement on draft targets and measures related to development of the Net Zero Climate Strategy, as well as views on engagement and divestment and offsetting.
14. The following steps were taken to ensure scheme members and Fund employers had sufficient opportunity to respond to the engagement exercise:
- Multiple emails to circa 40,000 scheme members (that the Pension Service held email addresses for) with a link to the consultation.
 - The engagement was available via the Pension Fund's website and was highlighted on the main page.
 - It was highlighted as part of the email that set out Members Annual Benefit Statements.
 - All employers were sent Employer Bulletins highlighting the engagement and asking them to respond and share the engagement with their staff.
15. The consultation sought the views of a wide variety of stakeholders and 1025 responses were received. Of the responses received by scheme members (1004), checks were undertaken using national insurance records in order to ensure they were members of the Fund. A breakdown is below.

	Total	1025
Scheme Members	Active	424
	Deferred	177
	Pensioner/Dependants	403
Employers	9	9 (circa 35% of total Fund Membership).
Investment Managers	LGPS Central, Partners, IFM, LaSalle, Aegon, Stafford Capital	6
Other	These included those who responded as a Scheme Member, but National Insurance numbers did not match. The responses were similar to the general response rate so remained within the responses analysed.	45.

16. Respondents were overwhelmingly supportive of the targets and measures set out within the engagement. In summary:

- **Net Zero by 2050, with an ambition for sooner** - There was a high level of support for the primary measure. Of the respondents 70% agreed with the ambition. Only 18% disagreed.
- **By 2030 a 40% reduction in net carbon emissions from 2019-reported levels** of the respondents 68% agreed with the proposed target 19% disagreed.
- **By 2030 reduce the carbon intensity of the Fund's equity portfolio by 50% from 2019 reported levels.** Of the respondents 64% agreed with the proposal, with 18% disagreeing with the target.
- 67% agreed with the statement **'reduce the proportion of the Fund with fossil fuel exposure within the equity portfolio (was 8.5% at 31st Dec 2019) by 31st March'**. 16% disagreed.
- 62% agreed with the statement **'Increase asset coverage to 90% by 2030 (currently at 45% 2022 Est) to be analysed for WACI'**. 12% disagreed.
- 71% agreed with the statement **'Increase allocation to climate solutions (use EU taxonomy) as defined by weight in clean technology from the base 2019 weight of 34.1% by 2030'**. 12% disagreed.
- 70% agreed with the statement **'Increase our percentage of portfolio underlying companies in material sectors with net zero targets, aligned to a net zero pathway or subject to direct or collective engagement to over 90% by 2030 for listed equities, corporate bonds, and sovereign bonds'**. 13% disagreed.
- 71% agreed with the statement **'By 2030, 90% of the Fund's financed emissions to be either net zero, aligned to a net zero pathway or subject to engagement programme to bring that about'**. 13% disagreed.
- 73% agreed with the statement **'County Council and LGPS Central targeting net zero by 2030 for their operations'**. 12% disagreed.

17. Within the engagement exercise the Fund also asked the following questions:

- 'With regard to carbon offsetting, what approach do you think the Fund should adopt? Please select all that apply'. Only 13% of respondents felt there should be no offsetting. 'Only offsetting if it removes carbon from the atmosphere' received the most support (42%). Both 'only natural offsetting such as trees' and 'offsetting acceptable if economically best option' received 26% support.

- ‘Which of the following most closely describes your view on whether the Fund should follow a policy of divestment or engagement?’ Views on engagement and divestment were less clear cut than previous questions. 35% preferred engagement, to 31% preferring divestment. However, a relatively large number (22%) were neutral on this view compared to the rates for this type of response to earlier questions in the engagement.

18. Respondents were also allowed to submit free text message comments during the engagement. As an example, the first question on “Net Zero by 2050, with an ambition for sooner” contained 527 open comments, of which 253 were supportive and recognised the importance of setting as ambitious targets as possible.

19. For the Board’s information key themes raised throughout the free text message comments related to the following points, which have been set out alongside the Fund’s response. Where possible the Fund integrated issues and concerns into the draft NZCS, which included emphasis on the limiting factors on the Fund, why climate risk is so important for the Fund to consider, and simplification of some of the targets. The Fund’s general response to some of the main points raised are included below:

Feedback Theme	Fund Response
The Fund should set more ambitious targets.	<p>At this point in time, it is unclear to officers how setting more ambitious targets can be achieved given the lack of data outside of the equities asset class to measure the Fund. The Fund is working with LGPS Central to increase asset coverage, in line with secondary measures which should help the Fund set more ambitious targets in the future.</p> <p>The Fund will commit to reviewing these targets at least every three years, with a view to bringing targets forward where the data supports the change. The targets will be monitored annually to ensure progress is made. The Fund is looking to make continual progress regarding decarbonisation.</p> <p>The Fund has focused on equities and the resulting scope 1 and 2 emissions due to the data currently available. The Fund did not want to delay initial action due to limited data availability. These targets will be expanded across the Fund’s investment portfolio in line with an implementation plan that is in development.</p>
Climate Change is not the Fund’s concern	Climate risk is a key consideration for the Fund due to its diversified investments across geographies and industries. Why this is important is set out in more detail in the draft NZCS at Appendix A.
Not Achievable	The Fund considers the targets to be achievable, however this will ultimately be subject to the caveats and limitations set out within the draft NZCS, for example, the reliance on international governmental commitments. However, the Fund will continue to work with partners and investment managers to progress decarbonisation from its 2019 benchmark level.

Feedback theme	Fund Response
Divest from top 200 fossil fuel companies and then engage with other investments.	<p>The Fund notes the view but does not currently propose to undertake overarching divestment. This is because divestment has no impact on world's carbon footprint and in some cases, divesting will remove 'green' investment exposure from the Fund.</p> <p>No company is insulated from the economic impact of extreme global warming. Engagement is therefore more compatible with our fiduciary duty and more supportive of RI, as it provides the opportunity to influence companies, something that is not possible if the investment is simply sold. Instead, the Fund will work with its investment managers to ensure they are taking into account forward-looking climate risk when making investment choices.</p> <p>The Fund will continue to take proper advice and act prudently when making investment decisions in this regard.</p>
That investments should be focused on development of local based renewable energy, home insulation, and other solutions to climate change and/or social good/social impact.	<p>Every investment must first achieve the return the Fund requires. The Fund is not equipped to make individual investments into local businesses and private investments need to be made through fund managers who have the necessary expertise and whose involvement avoids potential conflicts of interest.</p> <p>It is unlikely any commercial investment manager would specifically target Leicestershire or Rutland as a whole due to size, though they may make investments in the local area where they are attractive for financial returns. Information will be presented to the March 2023 Committee on issues in relation to 'local investing'.</p>
Which Pathway is being targeted, what stops the fund delaying action until 2040 on Net Zero and racing to the last decade.	<p>The Fund is aligning itself to a 1.5C pathway by 2050, the Fund is aware of the risks a less balanced pathway would cause in transition and physical risks which is set out in more detail within the draft NZCS.</p> <p>This is why the Fund includes 2030 interim targets to ensure progress is made at an appropriate pace.</p> <p>Furthermore the Fund will monitor progress annually to ensure it is making sufficient progress in line with the Paris Agreement.</p>
Focus the Fund's engagement efforts on banks, insurance, and	The Fund will continue to expand its engagement efforts with LGPS Central to target key companies to ensure that they are managing climate risk and are setting scientifically backed net zero plan in line with initiatives such as Climate Action 100+ (which covers 165 focus companies that account up to 80% of global corporate emissions), the Transition Pathway Initiative and the Science Based Targets Initiative.

other companies.	The Fund is a member of the Local Authority Pension Fund Forum which undertakes focused engagement. This includes banks as reported in the Q2 2022 update the Fund received. One of their key engagements aims relates to new financing for the oil and gas sector, given the International Energy Agency has said that no new oil and natural gas fields are needed in the net zero pathway.
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20. The engagement exercise also included questions on respondents' knowledge of the Fund's fiduciary duty and what the Fund invested in. The level of knowledge was relatively low. The Fund will pick this up as part of an action for communication with scheme members with the next review of the Administration and Communication Strategy. Work has also been undertaken to improve the information available on the Member Self Service Website.

Overview of the draft Net Zero Climate Strategy (NZCS)

21. The draft NZCS, attached at Appendix A was developed following, and inline with:

- The Institutional Investors Group on Climate Change (IIGCC), Net Zero Investment Framework
- Discussion at meetings and workshops with the Local Pension Committee.
- The response to the engagement exercise.
- The Fund's Climate Risk Report 2022 and Climate Scenario Analysis.
- Advice from the Fund's Investment Advisor, Hymans Robertson.
- Government commitments, with recognition of recently completed consultation on governance and climate risks and opportunities for the LGPS.

22. The NZCS outlines the Fund's strategic approach to managing climate risk, and proposed approach to achieving Net Zero by 2050, with an ambition for sooner. This includes some changes to the metrics and targets engaged on in order to simplify and better align the targets to the guidance provided by the Institutional Investor's Group for Climate Change.

23. The NZCS aligns with the investment belief set out in the Investment Strategy Statement that the Fund must ensure the portfolio is not overexposed to specific risk factors, ensuring it remains well-diversified across regions, technologies, and sectors. This may relate to technological risk and ensuring the Fund does not overvalue 'green' assets as part of a 'green bubble', does not have overexposure to new technology without proven track record, or be at risk from governmental policy reversals, for example.

24. The Strategy includes four key sections, further to the introduction, and general context on the Pension Fund. These sections relate to:
- **Climate Change Risks and Opportunities:** How the Fund will further embed climate risk and opportunities considerations. This will include working with Investment Managers to ensure they have considered climate risks and opportunities.
 - **Targets and Measures:** Net Zero by 2050, with an ambition for sooner, supported by interim and secondary measures to decarbonise the Fund's portfolio and increase investment in a range of climate solutions. This also sets out the current coverage of the Fund's assets, and limitations facing the Fund.
 - **Decision Making:** How the Fund can integrate targets and measures alongside best practice within the Fund's annual Strategic Asset Allocation, the Investment Strategy Statement and any investment decisions taken. The Fund can consider a range of investment approaches to manage risk and opportunities related to climate change, where there is a credible financial basis.
 - **Stewardship Engagement and Divestment:** In line with the IIGCC the Fund believes that engagement will drive the transition for a low carbon economy. This sets out a four-step plan of evaluation, engagement, voting and divestment.
25. The Strategy sets out that progress will be monitored on a regular basis, including a commitment to continue to produce annual public reports on the Fund's Climate Risk and work undertaken with partners such as LGPS Central, the Local Authority Pension Fund Forum, Hymans Robertson, and Investment Managers to address risks and opportunities.
26. The Pension Fund as a long-term investor must take a long-term view of its approach to investments. The Fund will review the NZCS and targets at least every three years and monitor progress annually as part of the Climate Risk Report. This will be supported through other Fund documents such as the Strategic Asset Allocation, Investment Strategy Statement, Funding Strategy Statement, and risk register.

Next Steps

27. The Fund will continue to develop the draft NZCS by development of an implementation plan for remaining asset classes, and clear engagement thresholds through LGPS Central. The Fund is also in talks with Managers to understand their own Net Zero targets and commitments and call on them to develop them where they have not been set. This has fed into the RI Plan 2023.
28. The Committee on 18 November 2022 approved a consultation on the draft Strategy given the importance of engagement and involving its scheme

members and employers to inform them of the risks of climate change on the Pension Fund and the measures it is taking to limit any negative impact on the Fund, as well as the work being undertaken to engage with companies to tackle real world emissions. The consultation is due to close 5 February 2023.

29. The consultation has been undertaken in the same way as the previous engagement, by emailing all scheme members (active, deferred and retired) scheme members that have email addresses available (circa 40,000), emailing all employers of the Fund, advertisement on the Pension Fund website, and as part of the presentation to scheme members at the Fund's Annual General Meeting.
30. To support the consultation the Fund also produced an eight-page summary document, given the length of the draft Net Zero Climate Strategy may act as a barrier to respondents. This is available here:
https://leicsmss.pensiondetails.co.uk/documents/W0544%20Pensions%20Net%20Zero%20Fund%20Summary%20Document%2005.pdf?language_id=1

Timetable for Decisions

31. Following formal consultation on the draft Strategy it is intended that the final draft of the NZCS will be presented to the Local Pension Committee for approval in March 2023, alongside the consultation outcome report.
32. While the Local Pension Board meeting is slightly outside of the consultation timetable, the Board is invited to provide any comments for consideration.

Equality and Human Rights Implications

33. The draft Strategy recognises many human rights factors are adversely affected by climate change. While there are no direct implications from the Net Zero Climate Strategy, as part of the Fund's approach to Responsible Investment the Fund seeks to ensure it continues to incorporate Environmental, Social and Governance issues in all areas of investment practices in line with the Principles for Responsible Investment as set out in the Investment Strategy Statement.
34. These considerations include engaging with companies through investment managers, the Local Authority Pension Fund Forum and LGPS Central to ensure they manage risks around the transition to a low carbon economy that includes key issues around labour and human rights.

Background Papers

Local Pension Committee – 18 November 2022 – Outcome of Engagement on Net Zero Climate Strategy Targets and Draft Strategy and Responsible Investing Update
<https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=6761&Ver=4>
 Local Pension Committee – 10 June 2022 – Responsible Investing Update
<https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=6759&Ver=4>

Local Pension Committee – 21 January 2022 - Responsible Investment Plan 2022

<https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=6757&Ver=4>

Local Pension Committee 26 November 2021 – Responsible Investing Update

<https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=6526&Ver=4>

Appendix

Draft Net Zero Climate Strategy

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