Climate Change Investment Policy Framework

Introduction

The Climate Change Investment Policy Framework was first issued in 2017 to help guide LAPFF member funds in their policy approach to current and future investment risks and opportunities that result from the impacts of climate change. Much has changed since LAPFF originally produced the framework document but as a high-level approach to formulating a policy approach, the principles remain valid and pertinent.

It is intended to help funds as they develop their investment strategies to accommodate climate change considerations. It sets out LAPFF's current view of suggested best practice guidance, recognising that funds will tailor the wording of their policies to reflect their own circumstances and investment objectives.

LAPFF recognises that member funds are at different stages in their active consideration of climate risk within their investment strategy. This framework is provided to member funds as guidance on what they might include in their own written statements and policies on climate change, wherever they are in their respective journeys to achieving best practice. It is not assumed that funds will cover all the points in the policy or in the amount of detail given. It is essential that whatever funds decide to do, that they are able to deliver, measure and report.

In developing the policy framework, consideration has been given to the requirements placed on English and Welsh Administering Authorities by LGPS Investment Regulations and DCLG Guidance on the content and coverage of investment strategy statements which shape the regulatory context for funds in relation to their stewardship and responsible investment activities. Related requirements for Scottish funds are set out by the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 which require administering authorities to prepare, maintain and publish a written Statement of Investment Principles.

The framework guidance is suggested wording and content for funds to consider when drawing up their own policy statements, but clearly this will be dependent on the individual circumstances of each fund, and funds should tailor statements accordingly. No changes have been made to the original wording, except to replace 'low carbon economy' with 'net zero carbon economy' and to remove 'by c.2050' from the following sentence ‘The Fund’s long-term goal is for 100% of assets to be compatible with the net zero-emissions ambition by c.2050 in line with the Paris agreement’ recognising that the Paris agreement does not specifically reference 2050 and funds will make their own decisions about relevant time-frames.

Developing a Climate Change Investment Policy Framework

LAPFF has long recognised the imperative to address climate change as a systemic and long-term investment concern for members, as it poses material financial risks across all asset classes with the potential for loss of shareholder value.

A number of studies have identified the potential for significant value loss as a result of the impact of climate change. The risks investors face are not limited to physical damage through severe weather events, or from rising temperatures and increasing natural resource scarcity. They include the impact of regulation to achieve targets for global emissions reduction set in Paris in 2015 and of the global transition to a net zero-carbon economy now underway. These are factors are already catalysing real world market adjustments and changes to energy production, supply and consumption patterns.

The timing and the consequences of climate change varies across business sectors but impacts all companies in multiple dimensions, as producers, consumers, tenants and asset owners. The risks and effects include emission and other resource related restrictions, asset stranding, technological obsolescence and increasing costs due to natural resource scarcity. For companies that are not recognising, planning for and adapting their business to the risks and opportunities associated with climate change, the outcome will be business failure.

These risks apply to investors in unsustainable companies or within exposed sectors which will suffer value loss. With this in mind, the LAPFF climate change investment policy framework was produced to provide support and context for the development of member funds’ investment and stewardship approaches.

There is broad acknowledgement that the COP21 Paris Agreement marked a significant change in the extent and seriousness of the global commitment to taking action on climate change. This has subsequently filtered down into policy changes and expectations for companies and investors. Signatories to the Paris Agreement in summary agreed to keep temperature rises well below 2 degrees and pursue ‘efforts to limit the temperature to 1.5 degrees C above pre-industrial levels’.

Since then there has been growing census around the need to achieve temperature rises of no more than 1.5 degrees following publication of the Intergovernmental Panel on Climate Change special report into global warming of 1.5 degrees in 2019. The report outlined the significant climate change risks to ecosystems with serious implications for society. These risks could be substantially reduced by limiting global warming to 1.5 degrees rather than 2 degrees, and to do so implies reaching net zero emissions by 2050. This is reflected in the Forum's policy for companies' business plans to be aligned with 1.5 degrees and the UK government has also enshrined its commitment to reaching net zero by 2050 through the 2019 Climate Change Act.

There have also been a range of other initiatives anticipating the actions and changes which will flow from the commitments made in Paris. The guidance produced by LAPPF reflects the insight and recommendations of several expert groups and commentators and will help members to benefit from and align with best practice.

In June 2017, the Bank of England published its strategic response to climate change. This reflected the Banks increasing focus on the impact of climate related financial risks within the broader context of actions being taken by central banks and by financial regulators globally and by the wider international community. For example, the Network of Central Banks and Supervisors for Greening the Financial System, which includes over thirty central banks, stated in 2019 that 'climate-related risks are a source of financial risk' and that 'there is a strong risk that climate-related financial risks are not fully reflected in asset valuations'. The Bank of England's Prudential Regulation Authority supervisory statement has placed requirements on banks and insurers to take a strategic approach to managing the risks that climate change poses and now expects firms to embed their approaches by 2021. Mark Carney, when governor of the Bank of England, stated that 'Financial decarbonisation of our economy is a major opportunity for long-term investors'. If pension funds are genuine long-term investors, then they may be well placed to benefit.

In 2018, the EC **High-Level Expert Group on Sustainable Finance, published its** final report on sustainable finance**. It found that investors' duties were essential to the investment process and should have a greater clarity and focus on sustainability. They also stated that 'if sustainability factors are to be properly considered in investment decisions, a pension fund's own risk assessment must include an assessment of new or emerging risks, including those related to sustainability'.**

The Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD) was set up to develop voluntary, consistent climate-related financial risk disclosures. It identified the need for good information from companies to address investors' needs when making decisions on capital allocation, as well as being applicable to investors themselves. The current emphasis is on voluntary standards but there is the implication that this may change in future. The final report with recommendations was published in 2017 and has led to companies adopting the recommendations and the FCA consulting in 2020 on introducing a requirement on listed companies to do so. The TCFD also included Asset Owners in the scope for reporting and highlights the importance of their role at the top of the investment chain. The disclosure framework recommended by the Taskforce is defined across four themes of: Governance; Strategy; Risk Management and Metrics and Targets.

LAPFF's original framework incorporated these four themes within its guidance to member funds, recognising that the TCFD framework will be widely considered as the best practice guide against which the activities of investors will be compared. This position remains, with the proposed adoption of TCFD recommendations into UK reporting requirement, and the themes form the structure of the policy framework. In line with the Task-Force's recommendations that organisations should report within mainstream finance reporting, it is recommended that member funds summarise their Policy on climate change within their Investment Strategy Statements or Statement of Investment Principles, Investment Beliefs, Investment Policy and/or Risk Register of funds as well as their Responsible Investment Policy. Ensuring that their annual reporting reflects this Policy will facilitate funds reporting in line with the Task-Force recommendations.

Climate Change Investment Policy

As a Local Government Pension Fund we are long-term investors with liabilities reaching beyond the year 2100. The objective of the Fund is to meet the current and future pension benefits of our members now and when they fall due.

Investment Beliefs

The Board and Management of the Fund believe that, over the expected lifetime of the Pension Fund, climate-related risks and opportunities will be financially material to the performance of the investment portfolio. As such, we consider climate change issues across the Fund and specifically in areas such as Strategic Asset Allocation, Investment Strategy, Investment Manager Selection and Risk Management with the aim of minimising adverse financial impacts and maximising the opportunities for long-term economic returns on our assets

The climate change policy will guide the Fund across Governance, Investment Strategy, Risk Management and Metrics and Goals.

Governance

The pension committee has responsibility for the direction of policy and the committee will have access to expert advice and have members with appropriate skills and knowledge. Responsibility for the implementation of this policy lies with the Fund's head of pensions and is adequately resourced. Regular monitoring of reports and impact assessments of policy implementation will be presented to the Committee and to the Local Pension Board.

Review period

We acknowledge that appropriate responses to the investment challenge of climate change are evolving rapidly and we commit to review our climate change strategy and policy every three years or otherwise as in line with the investment review cycle.

Investment Strategy

We are aware that climate change will impact all asset classes over the lifetime of the fund. As a result, many assets will be re-priced. The timing of this is uncertain and the impact will vary by asset class due to geography, liquidity and the underlying life of our assets. We recognise that there is uncertainty over the direction and speed of policy changes in this area. We aim to integrate climate change considerations into the Investment Strategy in a number of ways, as follows.

Asset Allocation

We will consider a range of alternative investment strategies available to manage risks and opportunities related to climate change. These may include active management of carbon risk which results in some reduction of exposure, such as a tilt towards low-carbon companies and assets, alongside company engagement and an increased allocation to low-carbon investment opportunities.

Investment Managers' Oversight

We will engage with investment managers to ensure they take account of climate change in investment practices and processes. Managers will be encouraged to ensure that active portfolios include positions that maximise the investment benefits, and minimise the risks, from climate change. All Investment Managers will be monitored on their approach to climate change as part of the regular review process.

Use of scenario analysis

We will review a variety of research and analytical materials to encourage the use of scenario analysis which provides estimations of relative performances of asset classes and sectors under different scenarios. When we have found scenario analysis that we consider robust and meaningful, we will request such research be utilised where possible in our Asset Allocation decisions and encourage our investment advisers to do likewise.

Climate-Related Investment Opportunities

Climate-related investment opportunities are available in areas such as energy efficiency, choice of energy sources, products and services and new markets.

We consider that currently there are limited climate-related investment opportunities in the public markets with more opportunities existing in the private markets across private equity, private debt, infrastructure and real assets. This has asset allocation implications due to the illiquidity and complexity of some of these asset classes.

Property is a significant asset class allocation and we are aware that buildings are responsible for around one fifth of total GHG emissions in the UK[1]. For directly-held properties, we will look to work with our property management teams on focus areas such as energy management and owner- occupier relations to reduce these emissions, and we will expect indirectly-held property managers to do likewise.

[1] Committee on Climate Change, Reducing UK emissions: Progress Report to Parliament (2020)

Risk Management
Climate risk will be measured and managed by integrating climate change into our risk management processes. We, or our managers on our behalf, will also consider the following

- include climate related financial risk on our risk register;
- monitor the scheme's carbon intensity;
- monitor policy dialogues for early indicators of change; and
- increase internal awareness of publicly available climate change scenarios and other risk analysis tools.

This will include seeking to reduce climate-related risks by improving the resilience of our investments where possible as well as identifying investments where appropriate in suitable low-carbon and net zero[2] assets to rebalance the investment portfolio away from carbon intensive assets.

Company Engagement
Where shares are held directly by the Fund, we identify, with guidance from investment managers and advisers, companies in our portfolios that are at the greatest financial risk from the transition to a net zero-carbon economy. We use our shareholder rights to engage directly, collaboratively (including with LAPFF) and through our fund managers, with companies exposed to the greatest risks, to encourage them to adapt their business models to ones that are better aligned to a net zero-carbon economy. We further encourage companies to take account of the Financial Stability Board's Task-Force on Climate-Related Financial Disclosure (TCFD) recommendations. Company responsiveness to engagement is taken into account in voting activity and the Fund will co-file and support relevant shareholder resolutions where appropriate. Where possible, we extend this engagement to investee companies across all asset classes.

Public Policy
Policy uncertainty is a major source of climate-related risk, as policy unpredictability makes the parameters of investment decisions and forecasts of economic outcomes less certain. As such the Fund commits to play an active role in engagement with policymakers and regulators whether directly, through its membership of LAPFF and other groups or both. This encompasses encouraging policy makers to address market failures and to provide an appropriate strategy and policy framework which encourages the transition to a net zero-carbon economy. We will report on our policy objectives and activities annually.

Collaboration
We believe collaboration with other investors helps influence and improve market best practice standards as well as strengthening the voice of asset owners and their

[2] The fund should identify what criteria it uses to identify a 'net zero carbon' asset

pension beneficiaries. Consequently, through our own activities and by our membership of the Local Authority Pension Fund Forum and other organisations, we aim to support 1.5 degree business model scenarios and participate in:

- engagement with companies to improve their approaches to climate change as well as encourage them to report on their actions for future business model scenarios;
- influencing policy makers;
- promotion of relevant research projects in areas such as developing standardised carbon intensity measures and investment initiatives that improve information flow and investment opportunities.

Metrics and Goals

We will report progress in our Annual Report and Accounts where possible in line with TCFD recommended metrics. We will also report additional metrics such as the number of collaborative and direct company engagement meetings held. Any measures of carbon intensity undertaken will be used to feed into investment strategy and risk management processes, to highlight specific risks and to guide company and investment manager engagement.

We aim to set targets that are measureable and reportable over time. These will cover climate related training, analysis of climate risk across the portfolio, addressing climate risk with asset managers and on asset allocation, including climate-related investment opportunities across asset classes. The Fund's long-term goal is for 100% of assets to be compatible with the net zero-emissions ambition in line with the Paris agreement. This decarbonisation goal will be regularly evaluated in line with our objective of maintaining long-term financial performance.