

PENSION FUND COMMITTEE – 5 JUNE 2020

INVESTMENT STRATEGY

Report by the Director of Finance

RECOMMENDATION

The Committee is RECOMMENDED to consider the responses to the recent consultation exercise and approve the changes to the draft documents as set out in the report and incorporated in Annex 3.

Introduction

1. At their March meeting, this Committee reviewed its Investment Strategy Statement and completed the fundamental review of its asset allocation following on from the tri-ennial Fund Valuation. For the first time, the Investment Strategy Statement included a Climate Change Policy as an annex to the document.
2. As required under the relevant Regulations and guidance, the Committee agreed to consult all key stakeholders on the draft Statement approved at the March meeting. This process was undertaken over a 6 week period from the beginning of April to the middle of May. This report sets out the key issues raised in the consultation responses and recommends the Committee to approve the final Investment Strategy Statement including the changes to the draft Statement set out in this report.
3. In the view of the Officers and as set out in the report, and number of the consultation responses highlighted key issues in the implementation of the Climate Change Policy rather than any specific changes to the Policy itself. This report therefore needs to be considered alongside the Climate Change Policy Implementation Plan included on today's agenda.

Consultation Exercise and Responses

4. The consultation pack contained a covering letter, a consultation document setting out the key issues for consideration and specific areas we would welcome comment and the draft Investment Strategy Statement and Climate Change Policy as approved at the March meeting. A copy of the consultation document is attached as annex 1 for information.
5. The consultation pack was emailed to all those who were invited/attended the Climate Change Workshop in November 2019. References to the consultation were included in the newsletter sent out to all Scheme Employers and in the Scheme Members newsletter. The consultation pack was also emailed to all

scheme employers and published on the Pension Fund's webpages. The consultation pack was also emailed to the officers with lead responsibility for climate change within the County, City and District Councils. The OCC lead officer subsequently arranged for a link to the consultation pack to be included in an all Manager email sent out within the County Council and on the home page of the County Council's intranet site.

6. By the close of the consultation period, we had received a total of 27 responses. A full list of respondents is included at Annex 2. As the consultation documents did not make it clear that responses would be published, we have not included the full responses within this report, but summarised the key issues raised. The full responses are available on request from Sean Collins by emailing him at sean.collins@oxfordshire.gov.uk.
7. The responses almost in their entirety focussed on the Climate Change Policy included as an annex to the Investment Strategy Statement itself. This is not unduly surprising as this was the major change to the current version of the Investment Strategy Statement and was the focus of the consultation document itself and the 4 areas where we were specifically seeking comment.
8. The majority of the responses welcomed the opportunity to comment on the Investment Strategy Statement, felt that the consultation document and the Statement itself was clearly presented, and supported the general direction of the Statement. There were a couple of responses which stated that they did not find the consultation documents helpful and found them difficult to follow. One would have welcomed more specific consultation questions.
9. Six of the responses followed a very similar format, based on a template made available from Fossil Free Oxfordshire. One further response was largely based on the full response from Fossil Free Oxfordshire.
10. The specific issues raised within the consultation responses in relation to the 4 areas highlighted in the consultation document were as follows:

Alignment of the Climate Change Policy with the Paris Agreement

- There was almost universal support for the inclusion of the Climate Change Policy and for it to be based on alignment with the Paris Agreement. No other universally accepted alternative was seen to be available/suitable.
- There a number of requests for clarification on what alignment meant. Concern was expressed that alignment to specific government pledges under the agreement was not enough to drive the required limits on temperature rises.
- There was also concern that a net zero target in 2050 was too distant a target, and we should be more ambitious (including one proposal we should aim that our investment portfolios are responsible for negative carbon emissions to repair previous damage to the environment) or bring in intermediate targets. Specific reference was made to the

Intergovernmental Panel on Climate Change's target of a 45% reduction in carbon emissions by 2030 (from a benchmark of 2010).

- One response raised the specific concern on a focus of net zero by 2050 as opposed to a focus on limiting temperature rises. It was argued that if the majority of activity to deliver net zero by 2050 was delayed to the end of the period, temperature rises could exceed 1.5°C or indeed 2°C in the interim.
- There was one response which felt it was unacceptable for the Pension Fund to be used for political purposes and argued that the Investment Strategy should be focussed on maximising financial return and that it was irresponsible to ignore the need for and the usefulness of fossil fuels.

The decision not to include a blanket divestment statement, but to focus on engagement and selective divestment

- The majority of respondents felt that the Policy should contain a blanket divestment policy in respect of the fossil fuel companies. Arguments to support this position included
 - the financial risks associated with stranded assets and/or the increasing number of legal cases seeking compensation from environmental damage already caused,
 - the moral and ethical arguments against investing in an industry driving the damage cause by climate change
 - the need to send a clear message to the fossil fuel companies and Governments that changes were required now,
 - investment in fossil fuel companies reduced the amount of investments in new sustainable energy sources
 - engagement takes time and we are facing a climate emergency
- There were a number of responses which accepted the Committee's position on not including a blanket divestment statement in the Policy at the current time, and/or the difficulties of implementing a blanket policy immediately given the need to develop suitable portfolios through Brunel. These responses though did make a number of further points including:
 - To be effective, engagement must be accompanied by clear criteria for the engagement, with clear targets set against agreed metrics with clear timescales and clear sanctions in the event of non-achievement. One response highlighted the current section on engagement within the Policy was based on belief statements rather than scientific evidence.
 - Any assessment of engagement with the fossil fuel companies must take into account the limited progress made over the past 30 years of engagement
 - Any fossil fuel company still exploring for new reserves of fossil fuels was arguably not aligned with the Paris Agreement – attention was drawn to the most recent analysis from the Transitions Pathway Initiative which stated that none of the oil and gas majors were currently aligned with a net zero or 1.5°C scenario.

- Divestment should follow as soon as possible following clear evidence that a company is not aligned to the Paris Agreement or has no credible plan to become so aligned.
- There was general support for engagement with non-fossil fuel companies to ensure they have credible plans to be aligned with the Paris agreement.
- The one respondent who was against the inclusion of the climate change policy also made the point that any divestment policy needed to take full account of the consequences of such divestment including on the impact on employment and the communities current benefiting from the fossil fuel companies active in their area.

Is the focus on climate risks appropriate given all the other risks facing the Pension Fund and the other UN Sustainable Development Goals (SDGs)?

- The vast majority of responses supported the focus on the climate change risks arguing that the significant potential financial consequences of not addressing the risks. Recent statements from the Government (including regulatory guidance on ESG disclosures) and other key figures in the financial sector (including the ex-Governor of the Bank of England) were quoted to support the case
- A number of the responses did make the point that whilst they agreed on the priority being given to the climate change risks, they would like to ensure other key ESG issues were not ignored, and that company performance against such issues and the SDGs was regularly measured and reported against.
- One response felt that equal attention should be paid to other issues including humanitarian, ecological and ethical matters.
- One response suggested a number of changes to the Statement to bring ethical considerations onto the same level as financial considerations.
- As noted above, one response did not believe that the Pension Fund should be driven by what they regarded as any political agenda and should manage our funds in a financially responsible and productive way for the scheme members.

What metrics should be used to assess compliance with the Policy?

- There were limited comments on what metrics should be used to ensure compliance with the policy, which is unsurprising given the lack of metrics developed to date by industry experts
- Metrics quoted included:
 - % of Fund invested in Fossil Fuel Companies
 - % of Fund invested in Climate Change Solutions
 - Carbon intensity of portfolios measured against total revenues
 - Carbon Emissions – ideally Scope 1, 2 and 3 where scope 3 emissions can be reliably measured
 - Percentage of companies signed up to the Taskforce on Climate-related Financial Disclosures Template
 - Scores against the Transition Pathway Initiative (TPI) Carbon Performance scores (concern was expressed that the TPI

Management Quality scores were too subjective and therefore were not currently a reliable metric).

- A few of the responses highlighted the difficulties of benchmarking performance against any of the existing Climate Change Scenarios developed by the International Energy Agency and others. These scenarios are only as good as the assumptions used to build them. Many of the current scenarios are based on significant levels of carbon capture and storage which are currently not supported by the available technology nor the planned future investment.
 - The absence of reliable metrics should not be an excuse not to take any action now. Decisions should be made on the best information possible today and reviewed as better data becomes available in the future.
 - Given that the Pension Fund is not a direct investor in the underlying companies, some responses highlighted the need to develop metrics to ensure the Committee could hold Brunel and their appointed Fund Managers to account. In addition to the above metrics which can be used to analyse individual Fund Manager mandate construction, the following metrics were identified to be used in monitoring Fund Manager performance:
 - Membership of various climate change associations such as New Zero Asset Owner Alliance, Climate Action 100+ etc
 - Voting records on Climate Change Resolutions
 - Engagement Records
11. Respondents to the Consultation document were not restricted to simply comment on the four key areas identified and a number made additional comments to those included above. The key other issues raised are as follows:
- There is a responsibility on the Pension Fund that alongside ensuring there are sufficient resources to pay pension liabilities in the future that there is a world fit to live in for those receiving future pensions
 - Members should be provided some choice over the individual assets their pension funds are invested in
 - All investment decisions are a matter of balancing competing risks and the Committee should be wary of unintended consequences of their investment decisions e.g. given the nature of the current renewables industry any increase in weighting to this sector (or reduction in the traditional energy sector) is likely to involve a switch of funds between the quoted and private markets, and between large cap and medium/small cap companies. Committees need data to assess the relative risk of the different investment choices
 - The current world-wide arrangements in respect to the Covid19 pandemic show just how much disruption and change everyone is prepared to accept in the face of a potential disaster – there is therefore real scope for fundamental change in light of the Climate Emergency
 - The implementation of any Policy needs to reflect the differences between the various asset classes, and different metrics and targets may have to be developed for each asset class. However, the principles from the Policy need to be applied across all asset classes.

- The breadth of the issues associated with climate change risks, the lack of universal accepted metrics, the dangers of unintended risks etc. all mean that any passive investment based on the major indices is unlikely to be consistent with the Paris Agreement. More specific climate related indices such as the FTSE TPI Climate Transition Index launched recently by an allocation from the Church of England should be reviewed, alongside passive funds targeting zero carbon or which exclude key sectors which contribute to the climate crisis including the fossil free companies, large food producers and those responsible for significant deforestation.
 - The Climate Change Workshop held in November with the breadth of contributors and attendees alongside the development of the Climate Change Policy should be seen as placing the Oxfordshire Pension Fund amongst the leading players in tackling the challenges of Climate Change. However, given the emergency nature of the risks, now is not the time to sit back and celebrate what has been achieved, but to focus on the significant changes still required.
12. Finally, a number of the respondents raised minor issues on wording or of a technical nature. Most of these have been incorporated into the latest version of the document contained as Annex 3 to this report.

Changes to the Draft Investment Strategy Statement

13. Having reviewed all the consultation responses, it is the view of Officers that there is considerable support for the Investment Strategy Statement and in particular the Climate Change Policy as currently drafted. The majority of comments do not oppose the principles set out in the Policy but focus on how the Policy will be implemented and monitored to ensure it delivers against its key objectives.
14. One of the key concerns expressed in the consultation responses though was about how the key objectives are currently worded in the Commitment section and the focus on the commitment to transitioning the investment portfolios to net zero emissions by 2050. It is accepted that this objective is on its own too far into the future, and can be met whilst temperature rises exceed 1.5°C or even 2°C.
15. The latest version of the Climate Change Policy contained within the proposed Investment Strategy Statement at Annex 3 of this report has therefore been amended (version at Annex 3 shows all tracked changes from the draft presented to the March Committee) to link in the commitment to the investment portfolios held by the Fund are consistent with a maximum temperature increase of 1.5°C. This reflects the intention of those who intended the Workshop in November 2019.
16. Officers have reviewed the proposal included in a number of responses to add an interim target to the Policy of a 45 % reduction in emissions by 2030, in line with the special report on Global Warming of 1.5°C published by the Intergovernmental Panel on Climate Change in 2018. This report identified the

need for emissions to reduce by 45% from their 2010 levels by 2030 if we were to be on target to hit net zero emissions by 2050 and to have no or limited overshoot of the 1.5°C target.

17. The main difficulty of including the 45% target in the Policy is the fact that it is benchmarked against 2010 levels and therefore difficult to measure retrospectively. Like the 2050 target, it also suffers from being a single point in time, with significant risk that there is insufficient movement in the intervening years
18. The difficulty of measuring against the 45% reduction target though should not mean we move away from the commitment in the current Policy to establish intermediate targets. The draft Policy included the commitment to establish intermediate targets every five years in line with the Paris Agreement Article 4.9. This though links to the pledges of individual governments, which as noted above was an area of concern in that they currently are not consistent with temperature rises of less than 2°C.
19. An alternative approach is therefore to benchmark the annual reductions in the total emissions from the investment portfolio from the current position against the targets set in the annual United Nations Environment Programme's Emissions Gap Report. This report sets out the current requirements on emission reductions consistent with 1.5°C and 2°C scenarios. The latest version of the Policy has been amended to reflect this alternative approach.
20. Another section of the Policy where changes have been made in light of the consultation responses is the section covering Engagement. The main concerns expressed through the consultation responses were about the section being too vague and based too much on beliefs. The section has been amended to make it clear that the Implementation Plan as well as setting clear targets and timescales for engagement will include the appropriate sanctions where deadlines are missed. The wording on divestment has also been amended to reflect the need for reasonable evidence that a company is aligned to the Paris Agreement rather than a simple belief.
21. An additional paragraph has been added to the risk section of the Statement to reflect the need for a robust risk management framework to ensure that investment decisions are not resulting in unintended consequences, and that climate changes risks are properly assessed against other key risks including liquidity.
22. An additional paragraph has also been added to the section on ESG Policy to reflect the requirement to develop a better suite of metrics reflecting all key ESG issues and the remaining Sustainable Development Goals to ensure that climate risks are not unduly prioritised, and that the wider ESG policy is being reflected through the investment choices made by Brunel and the underlying Fund Managers.
23. The final section changed following the consultation responses is the section on Monitoring and Reporting where some of the proposed metrics have been

added to the list to be used by the Pension Fund when assessing the compliance of the investments with the Climate Change Policy.

Responses to be Reflected in the Implementation Plan

24. Many of the points raised in the consultation responses whilst not requiring a change to the principles set out in the Policy did indicate areas that need to be appropriately covered in the Implementation Plan. These are mainly in respect of ensuring there are robust arrangements in place to monitor compliance with the Policy and to allow further actions to be taken (including revisions to the Policy) where it is clear more needs to be done to deliver against the key objectives.
25. Given the investment arrangements are channelled through Brunel alongside the other founder funds in the Brunel Pension Partnership, much of the Implementation plan will require collaborative working.
26. The key areas that need to be covered in the implementation plan based on the consultation responses are as follows:
 - The development of an internationally accepted 1.5°C scenario with clear arrangements in place to regularly review the reasonableness of the assumptions on which the scenario is based, particularly in respect of future carbon capture and storage
 - Setting benchmark scores for the metrics identified in the Policy and setting future targets and timescales for their achievement
 - Developing a framework to enable the regular monitoring of the Fund Managers employed by Brunel in respect of their ability to comply with the objectives of the Climate Change Policy, and how Brunel manage issues of non-compliance.
 - The development of clear metrics, targets, timescales and sanctions for the Engagement programme.
 - Work with Brunel to ensure portfolios across all asset classes include appropriate references to the need to be Paris Agreement aligned within portfolio specifications
 - Work with Brunel to identify early wins where the current metrics and availability of suitable products in the market allow the switch of assets to Paris aligned portfolios, with a particular focus on passive equities.
27. The Committee are invited to bear the above issues in mind when reviewing the draft Implementation Plan.

Consultation Issues not to be taken forward

28. There were a number of points raised within the consultation responses which in the view of the Officers could/should not be taken forward. These are as follows.
29. The consultation response which opposed the inclusion of the Climate Change Policy as following a political agenda rather than the Committee fulfilling their fiduciary duties was seen to failed to understand the widely recognised financial risks associated with climate change. As the Policy already makes clear, the fiduciary duty of the Committee is paramount, and the inclusion of the Climate Change Policy is because climate risk is seen as the greatest long-term financial risk to the Pension Fund.
30. Similarly, the comments seeking to raise ethical considerations to the same level of financial considerations is seen to conflict with the fiduciary duty of the Committee. All recent advice and guidance has made it clear that the Committee must always act in the best long-term financial interests of the Members. Non-financial factors including any ethical issues can be taken into account when making investment decisions, but only if there is no significant financial detriment and if the Committee have good reason to think that the decision would be supported by scheme members. The current wording of the Investment Strategy Statement reflects the latest guidance.
31. Although there was strong support amongst those who responded to the consultation on a blanket divestment from fossil fuel companies, there was no new evidence/argument to re-visit the decision previously made by this Committee. The Policy therefore re-iterates the view that a combination of engagement and selective divestment is seen as the most appropriate route to deliver a low carbon future. The Policy has also been amended to reflect the fact that this approach is dependent on having appropriate goals and timescales for the engagement and sanctions when these are not met. In line with the position set out within Brunel's own Climate Change Policy, this position will be kept under regular review and the decision re-visited again in 2022 as part of the Brunel stocktake.
32. Whilst not a key determinant of the decision not to support a blanket divestment approach, it should be noted that at the current time Brunel does not offer sufficient fossil free portfolios to implement a blanket divestment approach whilst maintaining an appropriately diversified set of investments. As set out in the Implementation Plan, we will continue to work with Brunel to ensure all portfolios going forward are aligned with the Paris Agreement and to stimulate the market to develop a much broader range of fossil free products.
33. Finally, it is not possible nor appropriate to take forward the issue of individual member choice. As a defined benefit scheme, the financial risks within the LGPS lie with the scheme employers and not the scheme members. Scheme employers would therefore bear the costs of decisions taken by individual members rather than the individuals themselves. There would also be considerable additional administrative costs in running a scheme where scheme members even had limited choice on the way their pension was invested. Asset allocation decisions therefore need to remain the responsibility

of this Committee, in line with their fiduciary duties, taking into account any clear views expressed by scheme members as a whole.

Other Issue

34. One issue not covered by the consultation exercise, that has been taken into account in preparing the latest version of the Investment Strategy Statement was the recent decision of the Supreme Court in the case of the Palestine Solidarity Campaign v HM Government. The Court ruled by a 3-2 majority that the existing guidance from the Secretary of State in respect of the preparation of Investment Strategy Statements was unlawful to the extent it prohibited pension funds operating sanctions, boycotts or divestment campaigns against foreign nations and UK defence industries, other than in accordance with UK Government foreign and defence policies.
35. Since the ruling, the Palestine Solidarity Campaign have written to chairs of Pension Fund Committees asking them to ensure that their Funds are not complicit in the Israeli violations of Palestinian human rights and international law and that scheme members concerns about any investments in companies guilty of any such violations are acted upon.
36. In light of the Supreme Court Decision, the line reflecting the unlawful guidance has been removed from the Investment Strategy Statement. However, officers believe that the deletion has no impact on the intent of the current Statement. The position remains that all environmental, social and governance factors which would include the issues raised by the Palestine Solidarity Campaign are taken into account when assessing all investment decisions.

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