

# Pensions Committee

2.00pm, Wednesday, 11 December 2019

## Stewardship and Engagement

Item number	5.6
Executive/routine	
Wards	All
Council Commitments	

### 1. Recommendations

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The Pensions Committee is requested to:

- 1.1 note the contents of this report

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Executive Director of Resources

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## Stewardship and Engagement

### 2. Executive Summary

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- 2.1 This report provides the annual update on the activity of the Lothian Pension Fund and Scottish Homes Pension Fund ('LPF') in relation to the stewardship of the assets of LPF, including the approach to environmental, social and governance (ESG) issues.
- 2.2 LPF pursues a policy of constructive engagement on such issues, which is consistent with fiduciary duties.
- 2.3 LPF has been a signatory to the Principles for Responsible Investment (PRI) since 2008, and so participates in the PRI's Reporting Framework, an annual assessment of LPF's responsible investment activities. This report summarises the PRI assessment and feedback for 2019.
- 2.4 LPF also participates in collaborative shareholder engagements through organisations including the Local Authority Pension Fund Forum (LAPFF), Hermes EOS (EOS) and Climate Action 100+, who act on behalf of asset owners with funds valued at over £250bn, £500bn and US\$35tn respectively. LPF continues to be represented on the LAPFF Executive Committee. This report provides an update on developments.

### 3. Background

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- 3.1 Lothian Pension Fund made a significant commitment to active and responsible share ownership by becoming a signatory to the PRI in 2008, and it has remained a signatory since then. Founded in 2006, the PRI (Principles for Responsible Investment) is the world's leading proponent of responsible investment. It is an independent, not-for-profit organisation (supported by the United Nations) that encourages investors to use responsible investment to enhance returns and better manage risks. Where consistent with fiduciary responsibilities, signatories commit to six principles, which are detailed in the main report.
- 3.2 LPF allocates meaningful resources to fulfil this commitment. A third-party provider of voting and engagement services (currently Hermes EOS), membership of the Local Authority Pension Forum (LAPFF) and third-party providers of environmental, social and governance (ESG) research (currently MSCI ESG Research) and private

fund monitoring (currently GRESB, which was added during 2019) are all components of LPF's responsible investment policy implementation, which support LPF's officers.

- 3.3 LPF pursues a policy of constructive engagement, which is consistent with fiduciary duties. The fiduciary duty responsibilities of the Scottish Local Government Pension Funds were clarified by the legal opinion sought and received by the Scheme Advisory Board of the Scottish Local Government Pension Scheme in June 2016. The opinion essentially reaffirmed the position taken by Senior Counsel in England & Wales, confirming that the advice is also applicable in Scotland. The legal opinion reinforces the approach taken by LPF to date.
- 3.4 LPF also participates in class action lawsuits in which a group sues another party to recover a loss in share value. LPF recovered £126,000 during the 2018/19 financial year.

## 4. Main report

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### Principles for Responsible Investment (PRI)

- 4.1 The Principles for Responsible Investment were developed by an international group of institutional investors to address the increasing relevance of environmental, social and corporate governance issues to investment practices.
- 4.2 Signatories to the PRI commit to six principles. The principles and LPF's compliance with each of them are laid out in paragraphs 4.3 to 4.23 below. An excerpt from the PRI website ([www.unpri.org](http://www.unpri.org)) describes the commitment thus:  
*"In Signing the Principles, we as investors publicly commit to adopt and implement them, where consistent with our fiduciary responsibilities. We also commit to evaluate the effectiveness and improve the content of the Principles over time. We believe this will improve our ability to meet commitments to beneficiaries as well as better align our investment activities with the broader interests of society."*

### Principle 1: we will incorporate ESG issues into investment analysis and decision-making

- 4.3 LPF believes strongly that environmental, social and governance (ESG) issues affect the financial performance of the companies in which they invest. They are essential ingredients in the estimation of investment risk and opportunity, and so LPF's investments are assessed in a holistic manner with ESG issues as an important part of that evaluation. Empirical evidence indicates that the shares of companies with improving ESG ratings are better investments than those that are simply highly rated. This supports LPF's approach of engaging with companies to improve environmental, social and governance practices as this can lead to better long-term outcomes for LPF and society as a whole.
- 4.4 The internal team integrates ESG issues into its actively managed fundamental portfolios as part of the formal due diligence process before investments are made.

The analysis of ESG factors is supported by the research of a specialist third party service (currently MSCI ESG Research), which provides ESG specific data, analysis and research to help identify the risks and opportunities that companies face. This ensures that consideration of ESG factors can be applied to the investment process using data that has been collated in a consistent manner.

- 4.5 As well as incorporating ESG issues into the analysis of internally managed portfolios, the internal team also monitors and engages at least quarterly with LPF's external managers, who are required to report on how ESG issues influenced their investment analysis and decision-making.
- 4.6 During the year, LPF joined the investor-led data provider GRESB to support assessment of the ESG risks, opportunities and impacts in property and infrastructure assets, and to promote sustainability.
- 4.7 LPF continues to track its 'carbon footprint' - the current data is presented in paragraph 4.31 of this report - and to monitor carbon-related risks, which inform decision-making and direct engagement activity.

**Principle 2: we will be active owners and incorporate ESG issues into our ownership policies and practices**

- 4.8 LPF's approach to Principle 2 is to vote all its shares and to engage with companies through its third-party provider and its portfolio managers, both internal and external. It also participates in class action lawsuits, in which groups of shareholders collectively sue a company to recover a loss in share value, or to exert influence on the company.
- 4.9 For the vast majority of holdings, Hermes Equity Ownership Services (EOS) votes and engages on behalf of LPF, and Baillie Gifford also votes and engages in relation to the holdings in the equity mandate that it manages for LPF.
- 4.10 Hermes EOS also engages at industry and country level to influence regulators, professional bodies and legislators by responding to relevant consultations, all with the aim of improving governance standards in the investment industry.

**Voting & Engagement**

- 4.11 Hermes EOS collates and reports voting and engagement data for calendar year periods. A complete summary of the voting statistics as well as a summary of voting disclosures, which explain the decisions to vote against management, are posted on LPF's website quarterly and a link is provided at the end of this report.
- 4.12 During calendar year 2018, LPF voted at the annual meetings of the 534 companies in which it was invested. There were votes on 7,397 resolutions, and LPF opposed 804 of them.
- 4.13 Hermes EOS also engaged on LPF's behalf with companies across the world on topics such as board structure, executive compensation and climate change. An overview of its current engagement plan is available in the Lothian Pension Fund Annual Report 2019/20.

- 4.14 Engagement activity is also undertaken for LPF by 1) the Local Authority Pension Fund Forum (LAPFF), which represents the majority of LGPS funds in the UK; and 2) the internal investment management team, which engaged as a participant member of the Climate Action 100+ initiative to curb greenhouse emissions, improve governance and strengthen climate-related financial disclosures.

### **Class Actions**

- 4.15 Following a court ruling in 2010, which narrowed the ability of investors to seek redress under US law, LPF's class action activity and recovered compensation have fallen to relatively low levels. Recoveries over 2018/19 amounted to £126,000, while recoveries this financial year up to 17 October 2019 were £185,000. Officers continue to monitor class action activity in relation to LPF's shareholdings and collect compensation where it is economical to do so.

### **Principle 3: we will seek appropriate disclosure on ESG issues by the entities in which we invest**

- 4.16 LPF, its partners and service providers seek to enhance ESG disclosure by investee companies. During 2018/19, LPF continued longstanding and successful efforts to enhance BP's disclosure. It co-filed a resolution at BP's AGM in May 2019 calling for greater transparency and disclosure on the company's approach to carbon emission and low-carbon transition planning. The resolution was backed by BP management and supported by 99.14% of investors. BP has since committed to provide investors with a new strategy consistent with the goals of the Paris Agreement, as well as providing further disclosure on capital expenditure and various company metrics and targets, including annual progress reports.
- 4.17 LPF's work with Climate Action 100+, an initiative with which our partners EOS and LAPFF are also heavily involved, seeks to increase disclosure of climate impact in line with the recommendations of the Taskforce for Climate-related Financial Disclosures (TCFD) as well as producing business strategy plans in-line with the aims of the Paris Agreement.

### **Principle 4: we will promote acceptance and implementation of the principles within the investment industry**

- 4.18 Lothian promotes the fact that it is a PRI signatory in its communications and on its website. It reports publicly the results of the PRI's annual assessment.
- 4.19 Scrutiny of investment portfolios includes the consideration of the principles, including how ESG issues are incorporated into the investment process, voting, engagement and the level of reporting. This applies to both internal and external portfolios, both at inception and on an ongoing basis.

**Principle 5: we will work together to enhance our effectiveness in implementing the principles**

4.20 Lothian collaborates with other investors to enhance effectiveness of implementing the principles. It does this in a variety of ways:

- by employing a third-party service provider (currently Hermes EOS, which has a client base with assets under ownership of £500 billion);
- through membership of the Local Authority Pension Fund Forum (LAPFF), which comprises over 80 UK local authority pension funds and 5 of the English and Welsh pools with combined assets of over £250bn. LAPFF's mission is *"to protect the long-term investment interests of beneficiaries by promoting the highest standards of corporate governance and corporate responsibility amongst investee companies."*
- through active 'participant membership' of Climate Action 100+, a collective engagement initiative supported by owners of US\$35tn of assets;
- by cooperating with other asset owners to share best practice through active participation in industry bodies, including the Scottish LGPS RI Working Group, the Cross-Pool RI Group (English and Welsh Pools) and the UK Pension Scheme RI Roundtable (large UK asset owners, such as the Church of England schemes, USS, NEST, the Environment Agency);
- through active involvement in local authority and industry conferences, including delivering training and presentations.

4.21 When the shares of the asset owners represented in the initiatives above are aggregated, the holdings are often significant enough that they can influence company boards. These collaborative efforts are beneficial to LPF as a relatively small asset owner, and they also encourage implementation of the principles more widely.

**Principle 6: we will each report our activities and progress towards implementing the principles**

4.22 As a signatory, LPF is obliged to report on its responsible investment activities annually through the PRI's Reporting Framework. This ensures accountability of signatories through a standardised transparency tool and promotes future development of responsible investment through annual feedback provided by the PRI. The PRI annual assessment report for 2019 is summarised below.

4.23 In addition to PRI reporting, all LPF's voting and engagement activity is made available on the website every quarter. In these reports, Hermes EOS presents progress of their engagement milestones and Baillie Gifford describes the detail of its engagement activity. A large section in the Lothian Pension Fund Annual Report 2018/19 is dedicated to LPF's Responsible Investment policy and activities.

## PRI Assessment Report 2019

- 4.24 The assessment report is designed to provide feedback to signatories to support ongoing learning and development. It measures progress against the six principles of the PRI and allows comparison with peers.
- 4.25 LPF's 2019 assessment report is available on its website and a link is provided at the end of this paper. The results are summarised in the table below.
- 4.26 LPF scored "A+" or "A" in all modules. Lothian Pension Fund expanded its reporting in 2018 to include alternative asset categories, including property, infrastructure and private equity.
- 4.27 There were significant changes to the Listed Equity assessment criteria in 2019, resulting in 'grade deflation' - the peer group scores were affected and declined in some areas, but Lothian obtained an A rating in all three areas of its Listed Equity management.

Assets Under Management	Module Name	LPF 2018	LPF 2019	Peer Median 2019
100%	Strategy & Governance	A	A+	A
<b>Indirect - Manager Selection, Appointment &amp; Monitoring</b>				
<10%	Listed Equity	A	A	A
<10%	Fixed Income - Corp Non-Financial	A	A	B
<10%	Private Equity	A	A	A
<10%	Property	A	A	B
<10%	Infrastructure	A	A	A
<b>Direct &amp; Active Ownership Modules</b>				
>50%	Listed Equity - Incorporation	B	A	B
>50%	Listed Equity - Active Ownership	A	A	B

- 4.28 In 2020, PRI intends to introduce mandatory climate reporting. Lothian provided voluntary data for the 2018 and 2019 reports. A comprehensive overhaul of reporting is also planned for 2021, which is likely to result in further 'grade deflation' with all median scores dropping to better differentiate participants and incentivise higher standards across the industry.

## Carbon Analysis

- 4.29 Lothian Pension Fund monitors the exposure of its underlying holdings to assess carbon output risk in the portfolio, and so sensitivity to future carbon pricing. Carbon footprinting seeks to measure the output of greenhouse gases from a firm's (or portfolio's) activities. It does not account for fossil fuel reserves, or operational stranded asset risk. Nor does it account for the "level 3" carbon output from products that the activities create.
- 4.30 There are various methodologies to measure a carbon footprint. LPF's preferred method uses 'carbon intensity', which is also the method preferred by the Taskforce for Climate-related Financial Disclosures (TCFD) for presenting carbon data. This is because it is an efficiency measure and less affected by general economic conditions than some other measures in use. Carbon intensity is calculated by dividing a firm's emissions (tons of CO<sub>2</sub> equivalent) by its sales (millions of dollars).
- 4.31 LPF's base for carbon footprinting is the data from Q4 2017. The table below compares that 2017 data for Fund and benchmark (MSCI All Countries World Index) with the data from the latest annual update in February 2019. It shows the percentage reduction in carbon intensity for both.

Portfolio/Benchmark	Carbon Intensity (tons CO <sub>2</sub> e/\$m sales) Quarter 4, 2017	Carbon Intensity (tons CO <sub>2</sub> e/\$m sales) Quarter 1, 2019	Change
Lothian - All Equities	243.8	225.9	-7.3%
MSCI All Countries World Index (Benchmark)	241.0	224.3	-6.9%

- 4.32 Although carbon footprinting provides useful insights, it is important to recognise that reducing exposure to, or completely divesting from, carbon intensive stocks in no way reduces global carbon emissions. It does reduce a portfolio's carbon footprint, which might seem appealing, but it has no real-world impact. It simply transfers ownership of the emissions to another party. In terms of real-world outcomes, it is systemic decarbonisation that matters, not portfolio decarbonisation. Systemic decarbonisation can only be achieved by engaging with listed systemic emitters to change business practices and shift capital allocation towards green solutions, along with denying new debt financing to systemic emitters and supporting green projects with new capital (debt and primary equity capital).
- 4.33 Although the carbon intensity measure does not identify exactly where carbon risk resides, the internal team is able to interrogate the data in a more granular fashion to assess individual company risks. Indeed, this analysis resulted in LPF joining the Climate Action 100+ initiative (<http://www.climateaction100.org/>) as a participant member, meaning that LPF is actively involved in an engagement with a large utility company. As a representative of a group of shareholders with over \$35tn in assets, the internal team has gained better access to management and the ability to influence systemically important carbon emitters to achieve alignment with the Paris



Agreement. The first progress report for the initiative was released in October 2019 and is available on the website above.

### **Local Authority Pension Fund Forum (LAPFF)**

- 4.34 The Pensions Committee has been represented on the Executive Committee of the LAPFF for many years. The latest representative, Councillor Alasdair Rankin, announced his intention to relinquish that post during the summer of 2019. John Anzani, Member Representative on the Pensions Committee, has now been elected to the Executive Committee of LAPFF following Pensions Committee approval in September 2019.

## **5. Next Steps**

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- 5.1 Mindful of its commitment to the PRI and its responsibilities to protect the long-term interests of beneficiaries, LPF will continue to undertake and report on the activities described in this report.

## **6. Financial impact**

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- 6.1 There is no financial impact as a result of this report. The costs of LPF's stewardship activities are included in the pension fund's budget. US class actions are conducted on a "no win no fee" basis. LPF is not currently involved in any non-US actions.

## **7. Stakeholder/Community Impact**

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- 7.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the pension funds and they are invited to comment on the relevant matters at Committee meetings.
- 7.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report. The forward planning of the Committees' agendas should facilitate improved risk management and governance for the pension funds.
- 7.3 There are no adverse sustainability impacts arising from this report.

## **8. Background reading/external references**

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- 8.1 The 2018/19 Annual Report is available here (pages 16-25 cover RI):  
[http://www.edinburgh.gov.uk/lpf1/downloads/file/947/lpf\\_audited\\_annual\\_report\\_and\\_accounts\\_201819](http://www.edinburgh.gov.uk/lpf1/downloads/file/947/lpf_audited_annual_report_and_accounts_201819)

LPFs' 2019 PRI assessment report is available at:

[http://www.edinburgh.gov.uk/lpf1/downloads/file/948/pri\\_annual\\_assessment\\_2019](http://www.edinburgh.gov.uk/lpf1/downloads/file/948/pri_annual_assessment_2019)

Hermes Lothian specific voting and engagement report is available at:

[http://www.edinburgh.gov.uk/lpf1/downloads/file/933/hermes\\_eos\\_annual\\_voting\\_and\\_engagement\\_report\\_2018](http://www.edinburgh.gov.uk/lpf1/downloads/file/933/hermes_eos_annual_voting_and_engagement_report_2018)

Further EOS voting and engagement information is available at:

<https://www.hermes-investment.com/uki/stewardship/eos-literature/>

Lothian Pension Fund's internal equity management ESG integration approach:

[http://www.edinburgh.gov.uk/lpf1/downloads/file/801/internal\\_equity\\_management\\_esg\\_integration](http://www.edinburgh.gov.uk/lpf1/downloads/file/801/internal_equity_management_esg_integration)

The CalPERS Effect

<http://www.mondovisione.com/news/calpers-effect-continues-to-improve-company-performance-shareholder-engageme/>

Lothian Pension Fund: [http://www.lpf.org.uk/info/68/responsible\\_investment](http://www.lpf.org.uk/info/68/responsible_investment)

United Nations Principles for Responsible Investment <http://www.unpri.org/>

Local Authority Pension Fund Forum <http://www.lapfforum.org/>

## 9. Appendices

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None