Pensions Committee

2.00pm, Wednesday, 24 June 2020

Policy Statement - Responsible Investment

Item number 5.10

1. Recommendations

The Pensions Committee (Committee) is requested to:

1.1 approve the Fund's new policy statement on Responsible Investment.

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Policy Statement - Responsible Investment

2. Executive Summary

2.1 The investment landscape has changed meaningfully since Lothian Pension Fund became a signatory to the Principles for Responsible Investment (PRI) in 2008. It has become increasingly important for investors, including investment managers and asset owners, to articulate their approach to Responsible Investment (RI).

2.2 The Fund has, therefore, drafted a policy statement to clarify its approach to RI. This expands on the Statement of Investment Principles (SIP), which is a statutory document. Although this policy statement (or 'Statement of Responsible Investment Principles') is not currently a statutory document, legislative progress in the Pensions Act makes it likely that a more detailed document such as this may become mandatory in the future.

2.3 The Policy Statement – Responsible Investment is presented in Appendix 1 for the Pension Committee's approval. It documents the Fund's approach to RI, with particular attention on the risks and opportunities surrounding Climate Change.

3. Background

3.1 Responsible Investment (RI) has become increasingly important to society since Lothian Pension Fund became a signatory of the Principles for Responsible Investment in 2008. While the Fund's Statement of Investment Principles (SIP) explains its approach to RI in broad terms, there is good reason to expand on those overarching principles in view of the increase in public interest and the growing trend to increased disclosure requirements in this area.

3.2 The new policy document in Appendix 1 provides a more detailed framework explaining the Fund's approach to RI, which the Committee reviews annually in December.

3.3 Unlike the SIP, the policy statement is not currently a statutory document, though legislative progress in the Pensions Act points to a more detailed document such as this potentially becoming mandatory in the future.

4. Main Report

4.1 The Policy Statement – Responsible Investment is set out in Appendix 1.

4.2 It documents the Fund's approach to RI, with particular recognition of the risks and opportunities surrounding Climate Change.

4.3 Core components of this policy document include:

- a commitment to the Fund's status as a Principles for Responsible Investment (PRI) signatory;
- the Fund's commitment to adhering to the UK Stewardship Code 2020;
- the Fund's commitment to reporting the climate impact of the its holdings in line with the recommendations of the Taskforce for Climate-related Financial Disclosures (TCFD); and
- the Fund's acknowledgement that the Paris Agreement of the United Nations Framework Convention on Climate Change is critical to halting anthropogenic climate change. This acknowledgement will drive engagement with the managements and Boards of non-Paris aligned equity holdings. A comprehensive review of holdings that are not aligned by 2025 will be triggered. Going forward, the clear intention is not to provide new capital to non-aligned companies.

4.4 The document is designed to clarify the Fund's approach to RI for all stakeholders. Equally important, it will guide investment decision-making by stating what is acceptable and why. It should aid elected members in responding to the many queries they receive on RI-related matters.

5. Financial impact

5.1 There are no direct financial implications of this report, although the approach to responsible investment is expected to lead to better management of risk and so improve long term returns.

6. Stakeholder/Regulatory Impact

6.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the fund and they are invited to comment on the relevant matters at Committee meetings.

6.2 There are no adverse, governance, compliance or regulatory implications as a result of this report.

7. Background reading/external references

7.1 None

8. Appendices

Appendix 1: Policy Statement – Responsible Investment

Appendix 1

LOTHIAN PENSION FUND

Statement of

Responsible Investment Principles

INTRODUCTION

- At Lothian Pension Fund (**LPF**), we believe that Responsible Investment (**RI**) supports the purpose of the Local Government Pension Scheme (**LGPS**) – the provision of retirement income for individuals. We believe that it should reduce the risk associated with the invested assets that the Fund owns to pay pensions when they are due.
- This Statement of Responsible Investment Principles (**SRIP**) complements LPF's Statement of Investment Principles (**SIP**), which is a statutory requirement codified in the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010. The SRIP explains our (LPF's) approach to the oversight and monitoring of the Fund's investment activities from a Responsible Investment (**RI**) and Stewardship perspective.
- RI is an approach to investing that aims to incorporate environmental, social and governance (**ESG**) factors into investment decisions, to better manage risk and to generate sustainable, long-term returns (according to Principles for Responsible Investment). Stewardship is the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society.
- RI is not the same as Ethical Investment (**EI**). EI is an investment approach determined by an investor's specific views, usually based on a set of personal values. These values can take precedence over financial considerations. LPF should not be considered as either an "Ethical" or an "Unethical" investor, but as a responsible steward of capital. The management of ESG issues is a question of identifying and mitigating material financial risks, not a question of ethics.

At LPF, we are guided in our roles as quasi-trustees, executive officers and investment managers by the legal principle of fiduciary duty. Guidance on our fiduciary responsibilities is provided by the Scottish Local Government Pension Scheme Advisory Board, which took legal advice on this matter (https://lgpsab.scot/fiduciary-duty-guidance/). It advises the Scottish Government (the Responsible Authority for the Fund) and Scottish LGPS Funds themselves on policy issues. We review this guidance on an ongoing basis to assess it against any changes to the legal or regulatory framework, and still believe it to be relevant.

- Our Pensions Committee (**the Committee**), comprising five elected councillors and two co-opted members representing employer and beneficiary interests, is responsible for fund oversight and policy setting. In carrying out its obligations, this group of quasi-trustees must take into consideration the views of its main stakeholders, members and employers.
- The City of Edinburgh Council (CEC) is the administering authority for the Fund, but the Fund is neither owned nor controlled by CEC. Pension fund assets, which are earmarked for pension payments over the life of the fund, are ringfenced from 'Council Money'. There are more than 80 employers and 85,000 members, whose pension payments will be funded by these and further employer and member contributions.
- At LPF, we are committed to acting as responsible investors by managing risk associated with ESG factors. Academic research supports the belief that successful engagement adds value to the investment process; and that divestment has no effect on company finances in the long term and

can produce perverse incentives in the short term[1]. Accordingly, we believe that responsible owners will engage with their investee companies and appointed managers, either directly or via their collaborative partners. Where material risks remain following engagement activity, we retain the ability to divest.

[1] *University of Edinburgh Master's in Economics Dissertation, "In response to the recent Paris Agreement, how might pension funds contribute to helping reduce global climate change through investment policy?", Cooper, 2019*

PRINCIPLES FOR RESPONSIBLE INVESTMENT

LPF is a signatory to the Principles for Responsible Investment (**PRI**), an organisation which supports and enables asset owners and asset managers to work collaboratively towards RI best practice. As a signatory, LPF has committed to implement the six principles with the aspiration of contributing to the development of a more sustainable global financial system.

Principle 1

We'll incorporate ESG issues into investment analysis and decision-making processes.
The implementation of LPF's investment strategy is delegated by the Pensions Committee to officers, who employ internal and external investment managers to invest the Fund's assets. How ESG issues are incorporated into investment analysis and decision-making processes varies according to the asset category and whether the mandate is internally or externally managed as follows:

Internal Equity investment: our investment managers analyse ESG data as part of the stock selection process and, on an ongoing basis, monitor ESG developments at underlying investee companies. Data and rating changes from independent providers trigger stock reviews.

External Equity managers: during the appointment process, we assess the approach of managers to incorporating ESG issues into their investment analysis and decision-making processes. We monitor the managers' implementation of the approach on a quarterly basis alongside all other investment matters, and review the PRI transparency reports of external managers, where available. Managers are encouraged to join PRI as signatories where they are not already members.

Internal Sovereign Bond investment: our investment managers analyse ESG reports and respond to government and market consultations, either directly or with our collaborative partners.

External Corporate Debt managers: during the appointment process, we assess the approach of managers to incorporating ESG issues into their investment analysis and decision-making processes. We monitor the managers' implementation of the approach on a quarterly basis alongside all other investment matters, and review the PRI transparency reports of external managers, where available. Our ambition is to appoint managers who will not provide new financing to companies or projects that are incompatible with the aims of the Paris Agreement.

Internal Direct Property investment: during the selection process, we assess the environmental efficiency and sustainability credentials of properties. We subscribe to GRESB and, in conjunction with the appointed property managing agent, ensure that ESG strategies and risk are integral at every stage of the ownership cycle. ESG improvement targets and performance will be incorporated into Fund strategy through asset management plans for owned assets and all new investment acquisition appraisals.

External Property managers: ESG management will be considered explicitly during the manager appointment process. Management and monitoring of ESG matters by the manager will be reviewed on a quarterly basis alongside all other investment issues. Where available, PRI Transparency and

GRESB reports are reviewed and, if they are not, managers are encouraged to articulate their approach to ESG and sustainability. Where appropriate, we seek improvement to both the management and implementation of that approach.

External Real Asset management (infrastructure, timber) managers: during the appointment process, we assess the approach of managers to incorporating ESG issues into their investment analysis and decision-making processes. We monitor the managers' implementation of the approach on a quarterly basis alongside all other investment matters, and review PRI transparency and GRESB reports of external managers, where available.

Principle 2

We'll be active owners and incorporate ESG issues into our ownership policies and practices.
Voting: we vote on all the resolutions at the Annual General Meetings (AGM) and Extraordinary General Meetings (EGM) of the Fund's equity holdings.

Shareholder resolutions: we also file or co-file shareholder resolutions on important issues at the Fund's investee companies in the interests of agitating for better governance.

Stock lending: LPF participates in stock lending, which generates revenue for the Fund and contributes to making investment markets more efficient. With the ambition to vote on 100% of equity holdings at all shareholder meetings, we recall stock on a systematic basis for voting.

Corporate engagement: we engage with our investee companies on material ESG issues. We use all methods at our disposal, including direct letters, open letters, company calls, company meetings, speaking at shareholder meetings, filing/co-filing of shareholder resolutions and proposing board members. We do this directly, through collaborative partners / service providers or alongside them.

Government engagement: we engage with government officials and regulators to ensure that markets run efficiently, and that rules and regulations proportionally protect the interests of the various market participants. This is done using all methods at our disposal, including direct letters, open letters, responding to consultations, working collaboratively with government departments and working collaboratively with regulators and quangos. We do this directly, through collaborative partners / service providers or alongside them

Manager monitoring: we actively and regularly monitor the approach of our investment managers to ESG issues, and what portfolio activity has occurred as a result of managing ESG risks.

Principle 3

We'll seek appropriate disclosure on ESG issues by the entities in which we invest.

Investee companies: we encourage the companies, whose shares the Fund owns, to report on relevant ESG metrics. These include the reporting of greenhouse gas emissions in line with the recommendations of the Taskforce for Climate-related Financial Disclosures (TCFD).

Investment Managers: we encourage the Fund's investment managers to provide transparency by reporting relevant and accessible ESG-related information. This includes their commitments to and alignment with the UK Stewardship Code 2020, the TCFD, the PRI and GRESB, where appropriate.

Principle 4

We'll promote acceptance and implementation of the Principles within the investment industry.

Commitment to PRI: we are transparent about being a signatory to the PRI and about how we implement the Principles. The Pensions Committee monitors the public assessment and transparency reports annually and these are published on the Fund's website to demonstrate implementation of the Principles and to promote them.

Investment Managers: we endorse the Principles to our managers and encourage them to become full signatories to PRI. Where this is not possible, we encourage our managers to use the six principles to guide their RI approach.

Partnership with PRI: we partner with PRI to promote the universal use of the principles, and work with PRI during any consultations to improve the effectiveness of the principles and further improve RI adherence across the industry.

Principle 5

We'll work together to enhance our effectiveness in implementing the Principles.

Collective Approach: we are committed to working collaboratively to increase the reach, efficiency and effectiveness of RI. We work with a host of like-minded partner funds, service providers and related organisations striving to attain best practice in the industry and to improve industry standards. A list of our collaborative partners and their roles are available on our website.

Principle 6

We'll each report on our activities and progress towards implementing the Principles.

PRI Assessment: we provide extensive details of our investment activities annually to the PRI for its independent assessment of our approach to RI.

PRI Reports: we publish our PRI transparency report annually on our website and we publish our PRI assessment results on our website and in our annual report.

TCFD: we are committed to report annually in accordance with Taskforce for Climate-related Financial Disclosures (TCFD) recommendations.

UK Stewardship Code: we report annually in accordance with the UK Stewardship Code requirements, and we are committed to adhering with the requirements of the new UK Stewardship Code 2020.

CLIMATE CHANGE AND THE TASKFORCE FOR CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD)

LPF recognises the importance of the Paris Agreement of the United Nations Framework Convention on Climate Change[2]. The central aim of the agreement is to strengthen the response to the global threat of climate change by:

- Keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius
- Strengthening the ability of countries to deal with the impacts of climate change through appropriate financial flows, a new technology framework and an enhanced capacity building framework
- Enhancing transparency of action and support through a more robust transparency framework.

LPF understands that the Paris Agreement is creating change that represents both significant risks to – and opportunities for – the Fund. As such we make the following commitments to climate monitoring and action:

- To continue to measure and report on carbon-equivalent emissions throughout the equity portfolios
- To continue our work with Climate Action 100+

[2] https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

- To continue to research and support the deployment of new impact capital into projects set to benefit from the transition to a low carbon economy
- To assess the carbon intensity of all assets (using estimates if necessary) by the end-2022 reporting cycle, supported by external managers and GPs
- Using data from the Transition Pathway Initiative (TPI), to engage alongside our collaborative partners to encourage companies to adopt business models and strategies that are in line with the aims of the Paris agreements. Our ambition is that all holdings covered by TPI will have achieved a level 4 assessment and have a business plan whose carbon performance is in-line with the Paris agreement or better by 2025.
- Using data from the Transition Pathway Initiative (TPI), we will not subscribe to new equity and fixed income issuance from companies whose business plans are not aligned with the aims of the Paris agreements at the time of the fundraising.

Financial returns from current and future investments will affect LPF's ability to fund future pension payments, and so we have committed to implement processes that adhere to TCFD recommendations as follows:

Governance: The Pensions Committee monitors stewardship of the Fund's assets at least annually. This includes reporting on RI issues and specific climate-related risks and opportunities. In accordance with the Fund's training policy, the Pensions Committee and Pension Board are required to undertake a minimum of 21 hours training[3], which includes training on RI issues and climate change-related risks and opportunities. The Pensions Committee:

- Affirms the Fund's commitment to integrate environmental, social and governance (ESG) considerations, such as carbon efficiency trends into its decision-making
- Delegates scrutiny and engagement with investment managers to Fund officers with advice from the Joint Investment Strategy Panel to ensure that they take ESG issues, including climate change and carbon risk, into account in their investment decision-making
- Affirms the Fund's policy of not divesting solely on the grounds of non-financial factors
- Notes that the Fund will monitor research on the link between ESG factors (including carbon-related factors) and financial performance to inform future investment strategy, such as stock selection criteria for quantitative strategies
- Agrees that the Fund will use its shareholdings in companies that perform poorly on carbon efficiency measures to influence engagement activity.

Strategy: we work individually and with our collaborative partners to drive for openness and transparency on climate related issues affecting our investments.

Risk Management: we subscribe to data services and analytical tools, including company and industry specific data, and scenario models, to help understand and manage the climate risk within the Fund. These are used by our internal managers and we monitor and assess the approaches taken by our external managers to risk management.

Monitoring: we use various monitoring tools with the aim of mitigating risk to Fund assets from trends towards net-zero carbon and more broadly from climate change. The Joint Investment Strategy Panel reviews and scrutinises RI issues and specific climate-related risks and opportunities

[3] https://www.lpf.org.uk/us/training-pension-committe-board/1

at least annually. The internal investment management team uses data services and analytical tools to monitor climate risk at as granular a level as possible.

Carbon Analysis: we note that carbon-equivalent footprinting produces a simple metric, which can be misinterpreted. It encourages selective divestment of the shares of high emission companies as some investors 'greenwash' their portfolios. Rather than divesting, we encourage our managers to incorporate an analysis of carbon output into their risk assessment of individual companies and their stocks. In addition, we actively engage with companies to align their business strategies with the targets of the Paris Agreement. Where analysis of carbon risk (or any other risk) points to poor financial outcomes, share divestment is, of course, an option.