



Pensions Committee

2.00pm, Wednesday, 9 December 2020

Stewardship and Engagement

1. Recommendations

The Pensions Committee (Committee) is requested to:

- 1.1 note the stewardship and engagement update.

Bruce Miller

Chief Investment Officer, Lothian Pension Fund

Contact: David Hickey, Portfolio Manager, Lothian Pension Fund

E-mail: David.Hickey@edinburgh.gov.uk | Tel: 0131 469 3611

Stewardship and Engagement

2. Executive Summary

- 2.1 This report provides the annual update on the activity of the Lothian Pension Fund and the 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 (RI) activities. This report summarises the PRI assessment and feedback for 2020.
- 2.4 LPF also participates in collaborative shareholder engagements through organisations including the Local Authority Pension Fund Forum (LAPFF), EOS at Federated Hermes (EOS) and Climate Action 100+, who act on behalf of asset owners with funds valued at over £300bn, US\$1.1tn and US\$47tn respectively. LPF continues to be represented on the LAPFF Executive Committee. This report provides an update on developments.
- 2.5 The Committee is advised that the contract for the voting and engagement provider will be tendered during 2021.
- 2.6 The appendix to the report provides an overview of the service providers and voluntary initiatives that support and enable LPF's commitment to RI.

3. Background

Governance Review

- 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 (RI). 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 LPF Statement of Responsible Investment Principles (SRIP) ([link in section 7 of this report](#)).
- 3.2 LPF allocates meaningful resources to fulfil this commitment. A third-party provider of voting and engagement services (currently EOS at Federated Hermes (EOS)), membership of the Local Authority Pension Forum (LAPFF), a third-party provider of environmental, social and governance (ESG) research (currently MSCI ESG Research) and private fund monitoring (currently GRESB), all support implementation of LPF's RI policy.
- 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 £207,500 during the 2019/20 financial year.

4. Main Report

LPF - Principles for Responsible Investment (PRI)

4.1 The Principles for Responsible Investment (PRI) 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. An excerpt from the PRI website (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.”

4.3 The six principles, and LPF’s compliance with each of them, are laid out in LPF’s Statement of Responsible Investment Principles (SRIP). This document describes LPF’s approach to stewardship, voting and engagement as well as its commitment to the goals of the Paris Agreement on climate change and how the fund manages climate risk.

Voting & Engagement

4.4 For the vast majority of holdings, EOS votes and engages on behalf of LPF. Baillie Gifford also votes and engages in relation to the equity mandate that it manages for LPF.

4.5 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.

4.6 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 (link in section 7).

4.7 During calendar year 2019, LPF voted at the annual meetings of the 546 companies in which it was invested. There were votes on 7,871 resolutions, and LPF opposed 909 of them.

4.8 EOS also engaged on LPF’s behalf with companies across the world on topics such as board structure, executive compensation and climate change. Detail of EOS’s

engagements on behalf of LPF can be found in the EOS voting and engagement report on the LPF website (link in section 7). An overview of EOS's current engagement plan is available in the Lothian Pension Fund Annual Report 2019/20 (link in section 7).

- 4.9 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 has been engaging as a participant member of the Climate Action 100+ initiative to curb greenhouse emissions, to improve governance and to strengthen climate-related financial disclosures.

Collaboration

- 4.10 Lothian collaborates with other investors to enhance effectiveness of implementing the PRI principles. It does this in a variety of ways:
- by employing a third-party service provider, currently EOS, who *“engage companies on strategic and sustainability concerns to promote investors’ long- term performance and fiduciary interests”* and represent approximately \$1.1tn of assets;
 - through membership of the Local Authority Pension Fund Forum (LAPFF), whose 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”* and who represent some £300bn of assets. LPF has been represented on the Executive Committee of the LAPFF for many years. The latest representative is John Anzani, Member Representative on the Pensions Committee;
 - through active ‘participant membership’ of Climate Action 100+, a collective engagement initiative supported by owners of US\$47tn 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); and
 - through active involvement in local authority and industry conferences, including delivering training and presentations.
- 4.11 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.

- 4.12 LPF engages with investment management firms to promote RI. During 2019/20, LPF led a collaborative engagement with Blackrock, the world's largest investment manager. LPF was supported by Scottish Widows, Brunel Pension Partnership and the Church Commissioners in an effort to improve its record on climate-related voting activity. The group was given access to the executive board at BlackRock, which enabled it to influence BlackRock's decision to join the collaborative Climate Action 100+ effort as a participant member.
- 4.13 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.

Disclosure

- 4.14 As a signatory to PRI, LPF is obliged to report on its RI activities annually through the PRI's Reporting Framework. This ensures accountability of signatories through a standardised transparency tool and promotes future development of RI through annual feedback provided by the PRI. The PRI annual assessment report for 2020 is summarised below.
- 4.15 In addition to PRI reporting, all LPF's voting and engagement activity is made available on the website every quarter. In these reports, EOS presents progress of its engagement milestones and Baillie Gifford describes the detail of its engagement activity. A large section in the Lothian Pension Fund Annual Report 2019/20 is dedicated to LPF's RI policy and activities.
- 4.16 LPF has also committed to reporting in line with the Financial Reporting Council's (FRC) Stewardship Code 2020 recommendations. These reflect a significant overhaul of the prior stewardship code and feature a much expanded "comply and explain" requirement for signatories covering 12 different principles. It is envisaged that this will be produced as a stand-alone document that will be summarised in the annual report.

PRI Assessment Report 2020

- 4.17 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.
- 4.18 LPF's 2020 Assessment Report is available on its website and a link is provided at the end of this paper. The results, summarised in the table below, show that LPF scored 'A+' or 'A' in all modules.

Assets Under Management	Module Name	LPF 2019	LPF 2020	Peer Median 2020
100%	Strategy & Governance	A+	A+	A
Indirect - Manager Selection, Appointment & Monitoring				
<10%	Listed Equity	A	A	A
<10%	Fixed Income - Corporate Non-Financial	A	A	A
<10%	Private Equity	A	A	A
<10%	Property	A	A	A
<10%	Infrastructure	A	A	A
Direct & Active Ownership Modules				
>50%	Listed Equity - Incorporation	A	A	A
>50%	Listed Equity - Active Ownership	A	A	B

- 4.19 In 2020, PRI introduced 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 'grade deflation' with all median scores dropping to better differentiate participants and incentivise higher standards across the industry.

Carbon Analysis

- 4.20 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.
- 4.21 There are various methodologies to measure a carbon footprint. LPF's preferred method uses 'weighted average 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 CO₂ equivalent) by its sales (millions of dollars).

- 4.22 LPF's base for monitoring the carbon footprint is data from Q4 2017. The table below presents that data for LPF and its benchmark (MSCI All Countries World Index) as well as the data from the annual updates in 2019 and 2020 and the percentage reduction for both portfolio and benchmark.

Portfolio/Benchmark	Carbon Intensity*				
	Q4 2017	Q1 2019	Change	Q1 2020	Change
Lothian - All Equities	328.6	325.2	-1.0%	294.9	-9.3%
MSCI All Countries World Index	218.9	200.2	-8.5%	178.1	-11.0%

**Carbon Intensity is the weighted average carbon intensity of the portfolio measured as CO₂e / \$M sales*

- 4.23 As detailed in the SRIP, LPF has an ambition to report on carbon emissions for all asset classes for the 2022/23 financial year. The fund is engaging with managers and standard setters to allow us to achieve this.
- 4.24 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).
- 4.25 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 \$47tn 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 most recent progress report for the initiative was released in October 2020 and is available on the website above.

Class Actions

- 4.26 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 2019/20 amounted to £207,500, while

recoveries this financial year up to 02 November 2020 were approximately £20,000. Officers continue to monitor class action activity in relation to LPF's shareholdings and collect compensation where it is economical to do so.

5. Financial impact

- 5.1 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.

6. Stakeholder/Regulatory Impact

- 6.1 The Pension Board, comprising employer and member representatives, is integral to the governance of LPF and they are invited to comment on the relevant matters at Committee meetings.
- 6.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report.

7. Background reading/external references

- 7.1 The 2019/20 Annual Report is available here (pages 27-41 cover RI):
<https://www.lpf.org.uk/downloads/file/130/annual-report-and-accounts-2019-20>
- LPF's Statement of Responsible Investment Principles (SRIP) is available at:
<https://www.lpf.org.uk/downloads/file/129/statement-of-responsible-investment-principles>
- LPFs' 2020 PRI assessment report is available at:
<https://www.lpf.org.uk/downloads/file/24/pri-assessment-2020>
- EOS at Federated Hermes's Lothian specific voting and engagement report is available at:
<https://www.lpf.org.uk/downloads/file/112/hermes-eos-annual-report-2019>
- Further EOS voting and engagement information is available at:
<https://www.hermes-investment.com/uki/stewardship/>
- Lothian Pension Fund: <https://www.lpf.org.uk/investment/responsible-investment?documentId=40&categoryId=2>
- Principles for Responsible Investment <http://www.unpri.org/>
- Local Authority Pension Fund Forum <http://www.lapfforum.org/>

8. Appendices

Appendix 1 – Stewardship and Engagement initiatives, service providers and data providers

Stewardship and Engagement

Pensions Committee

9 December 2020

Appendix 1, Item 6.4

Stewardship and Engagement Initiatives

The Pensions Committee of Lothian Pension Fund (LPF) became a signatory to the Principles for Responsible Investment (PRI) in 2008 and by adopting its Statement of Investment Principles (SIP) at least annually since then, it has reaffirmed its commitment to Responsible Investment (RI).

In June 2020, the Pensions Committee endorsed a new Statement of Responsible Investment Principles (SRIP), which documents the Fund's approach to RI in greater detail.

This appendix to the Stewardship and Engagement paper describes the various commercial arrangements and collaborative initiatives that officers of the Fund are undertaking to apply the principles agreed by the Pensions Committee. The commercial relationships are naturally kept under regular review to satisfy procurement regulations and the collaborative initiatives are similarly reviewed to ensure that resources are allocated effectively.

Criteria

There are more investor initiatives that fit the description of RI initiatives than it is possible to support. Consequently, LPF applies three main criteria when considering potential activities or relationships:

- They must be aligned with the stated values of LPF as outlined in the SRIP
- They must provide valuable data or insight that can inform the investment process or satisfy the disclosure requirements of the fund
- The time commitment and financial cost must be deemed proportionate to the benefit that the initiative can provide for the fund

Reporting and Disclosure

Principles for Responsible Investment (PRI)

LPF has been a signatory to the PRI since 2008. The six principles of the UN-backed organisation have guided LPF's approach to RI over more than a decade. PRI is the global standard for assessing investors' approach to RI and it is highly proactive in driving higher standards of RI disclosure across the world. The values of LPF and PRI are clearly aligned.

Resource requirements: Very high. LPF's internal team commits in excess of 100 hours of total staff time, including senior leadership time, to satisfy the requirements of being a PRI signatory.

Stewardship Code 2020

LPF has reported on its compliance with the Financial Reporting Council's (FRC) Stewardship Code since its launch in 2012. In 2020, the FRC announced a significant revision to its existing stewardship code, featuring a much expanded "comply and explain" requirement for signatories covering 12 different principles. The Code is voluntary.

Resource requirements: very significant. It is expected that a final report meeting the requirements of the UK Stewardship Code 2020 will run to over 60 pages. It is hoped that a single report will also be able to cover requirements under the **Shareholder Rights Directive ii (SRD2)** and the **EU Sustainable Finance Disclosure Regulations (SFDR)** as there is a great deal of overlap between these requirements, and indeed, those of the PRI. There is no escaping the tsunami of incoming disclosure regulations facing the investment management industry. LPF has committed to reporting in line with the UK Stewardship Code 2020 in the recent SRIP and intends to review the benefits relative to other voluntary activities.

Taskforce for Climate-related Financial Disclosures (TCFD)

The TCFD is a voluntary initiative launched by the Bank of England's Financial Stability Board (FSB). It has quickly become the global standard for disclosure of climate risk for both corporations and investment managers. The framework sets out sensible methods for incorporating climate risk into the investment decision making process and asks signatories to report on them. LPF has reported in line with TCFD guidance in its annual report for the last two years. New standards in carbon reporting for investible assets are being developed by the Partnership for Carbon Accounting Financials (PCAF) and are likely to allow LPF to extend TCFD aligned reporting to all assets, in line with the ambition of the SRIP.

Resource requirements: moderate. Processes for managing climate risk are already embedded into the investment process, and disclosure is straightforward. Production of carbon metrics and possible scenario analysis will, however, increase complexity. Currently voluntary, TCFD reporting is expected to become mandatory for financial year 2022.

Service Providers

EOS a Federated Hermes (EOS)

EOS has been the voting and engagement provider for LPF since 2008. A comprehensive approach to voting and engagement is at the heart of RI. EOS provides regular reports on the activities that it undertakes for LPF and is a regular presenter at training events and Pensions Committee meetings where it describes the progress of its various engagements. This is a commercial arrangement and the contract for a voting and engagement service provider is due to be re-tendered during 2021.

Resource requirements: LPF has opted to outsource a large part of its voting and engagement activity to a large experienced provider as it has the scale to spread costs and undertake a much broader range of engagement activity than would be possible for the existing internal team. Resource requirements are, therefore, relatively low.

Local Authority Pension Fund Forum (LAPFF)

The LAPFF is a collective initiative of over 80 local authority pension fund members. Its mission is to promote the highest standards of corporate governance to protect the long-term value of local

authority pension funds. The LAPFF has a much narrower range of engagement activity than EOS as it has smaller resources.

Resource requirements: Moderate. The LAPFF Executive Board comprises Pensions Committee members from around the UK and some officers. For several years now, LPF has had a member of the Pensions Committee on the Executive Board supported by an officer attending regular meetings and the annual conference.

MSCI ESG Research

To ensure that LPF is integrating environmental, social and governance (ESG) considerations into the investment decision-making process, it procures data, including carbon reporting data, and analysis from a provider on a commercial basis. The current provider is MSCI ESG Research. These data and research are central to the investment process to assess risk and return and to the reporting carried out by LPF.

Resource requirements: the internal team use MSCI's research output to inform investment decisions, so this is not an optional activity that requires incremental time resource. Cost / benefit analysis is assessed annually for all research requirements, and this is especially important in the ESG research area as the market has been evolving quickly.

GRESB

Originally the Global Real Estate Sustainability Benchmark, GRESB is now the primary ESG reporting tool for real estate and infrastructure assets. Managers submit data and the GRESB methodology allows investors to compare managers and assess where any particular ESG risks may lie within a portfolio of real assets. The internal real assets team is integrating GRESB data into its overall process and planning to report direct real estate data to GRESB by 2022. The coverage of managers for infrastructure assets is less advanced.

Resource requirements: significant time resource; cost to access the data is assessed alongside all other investment specific data and research requirements.

Additional Voluntary Initiatives

Climate Action 100+

Climate Action 100+ is the world's largest collective engagement initiative, representing over \$47tn in assets under management committed to its aims. LPF has been a participant member since 2019 and a key contributor to the engagement efforts with Finnish Utility Fortum. While the main point of involvement in CA100+ is to gain further insight into the climate risks of the equity portfolio, it demonstrates that LPF is taking an active role in promoting RI.

Resource requirements: moderate time resource for engagement planning and meetings, totalling around 20 hours a year.

Transition Pathway Initiative (TPI)

The TPI is an asset owner led initiative which analyses the low-carbon transition readiness of nearly 200 companies (and growing). The tool ranks management quality (1-4) and Carbon Performance (based on Paris Alignment). LPF is a signatory of TPI, part of a community of investors representing \$22.5tn in assets. The TPI tool is key to our plans to deny new capital to non-Paris Aligned companies (encapsulated in the fund's public mantra "Engage your Equity, Deny your Debt").

Resource requirements: none.

CDP

Launched 15 years ago, the CDP (formerly the Carbon Disclosure Project) engages with companies to ensure that an effective carbon emissions strategy is made integral to their operations. It provides industry specific guidance on how to achieve this and it collects a great deal of environmental data in the process. CDP has changed its model over the last two years, introducing a layered membership with various levels of research available. LPF support the aims of CDP but uses other sources for its data.

Resource requirements: no time resource; small financial cost.

Institutional Investor Group on Climate Change (IIGCC)

The IIGC is the main European body on investor collaboration on climate change. IIGCC are the EMEA administrators of the Climate Action 100+ initiative. They have multiple programmes on Policy, Corporate Engagement, Investor Practices and have opportunities to collaborate on a number of practical projects aimed at reducing global carbon emissions. IIGCC is asset owner led and focussed on reducing climate-related risks in member funds. IIGCC has recently launched a net-zero investment framework which is undergoing final review post-consultation. It is expected that this framework could be adopted by LPF as part of a future net-zero ambition.

Resource requirements: Small financial cost; time resource is open ended and would depend on LPF capacity.