

WIRRAL COUNCIL

PENSIONS COMMITTEE

22 JANUARY 2018

SUBJECT:	CLIMATE RISK MANAGEMENT
WARD/S AFFECTED:	ALL
REPORT OF:	DIRECTOR FOR CORPORATE RESOURCES & REFORM
KEY DECISION?	NO

1. EXECUTIVE SUMMARY

- 1.1 The purpose of this report is to request that Members approve the proposal to move into low carbon passive equities as part of implementing the climate risk management policy for Merseyside Pension Fund (MPF).
- 1.2 Appendix 1 to the report contains exempt information. This is by virtue of paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972, i.e. Information relating to the financial or business affairs of any particular person (including the authority holding that information).

2.0 BACKGROUND AND KEY ISSUES

- 2.1 Pensions Committee has previously approved the development of a Climate Risk Strategy for MPF, based on climate-related investment beliefs: that climate change is a systemic risk and thus, a material long-term financial risk for investors who must meet long-term obligations. In March 2017, Members approved the Fund's Investment Strategy Statement, containing the following pertinent investment beliefs:
- *There exists an equity risk premium, namely that investors are rewarded over the longer term for making investments in equities or other risk assets;*
 - *Environmental, social and governance (ESG) factors will materially affect investment performance over the long term*
 - *MPF can select optimal investment strategies that integrate ESG information to drive the construction and adjustment of investment portfolios.*
- 2.2 Members have requested that plans be brought forward for measuring and reducing the carbon intensity of existing portfolios as part of pursuing a decarbonisation goal. The proposal contained in this report is a step toward that goal.

2.3 Passive Equities

As at 31st December 2017, MPF's assets were valued at £8.6 billion, of which 13% comprised passive equities (managed to track the returns produced by stock-market indices):

£468 million	UK equities (tracking FTSE All Share index)
£663 million	US equities (tracking FTSE North America index)

These passive equities portfolios are managed in low cost pooled investment vehicles (MPF's assets are co-mingled with those of other investors) by State Street Global Advisers and they track standard market capitalisation-weighted indices. They make up one quarter of MPF's overall allocation to equities. Their purpose as part of MPF's investment strategy is to provide a relatively low risk exposure to the return available from equity markets, or the 'equity risk premium'.

- 2.4 MPF is exploring alternative ways to access this risk premium, due to recognised inefficiencies in market cap-weighted indices. In terms of climate risk, the indices tracked in the passive equities portfolio are agnostic to climate risk and contain high concentrations in stocks and sectors that are vulnerable to climate risk. It is proposed that, as part of a restructuring of the passive equities portfolio: one third is allocated to a low carbon index-tracking solution; that the low carbon index selected has a reduced carbon foot-print (using measures of carbon emissions intensity and fossil fuel reserves) relative to current indices used; and that it remains capable of replicating the return of its 'parent index' within an acceptable range of tolerance.

The objective will be to provide a return in line with the market, on a more climate-resilient basis (carbon reduction acting as a hedge against climate risk) with some potential for long-term outperformance as the transition to a low carbon economy gains momentum. However, it should be noted that some increase in performance volatility may be experienced in the short-term (for example, in the event of upward movements in oil & gas prices).

- 2.5 It is likely that an increase in costs would be associated with implementing this proposal, due to the relative lack of scale of assets invested in such strategies and the licensing costs associated with specialist index benchmarks. However, any cost increase would be from a very low base and could be off-set in time by the risk reduction benefits outlined. The past 18 months has seen the launch of notable institutional-scale low carbon index funds by leading asset management groups, which begins to address the scaling issue. MPF has means to efficiently procure suitable support for implementing this proposal, via the National LGPS Frameworks initiative.
- 2.6 An exercise to measure MPF's carbon foot-print is underway and it is expected that the findings will be reported to Pensions Committee in March 2018 (and subsequently included in the Fund's public reporting). This will provide further

means to calibrate the amount of risk reduction to be sought and illuminate the contribution of restructuring the passive equities portfolio toward this goal.

3.0 RELEVANT RISKS

3.1 The Financial Stability Board-backed Taskforce on Climate-Related Financial Disclosures (TCFD) has classified climate risks into two major categories – transition risks and physical risks. Transition risks relate to the impacts (including costs) of public policy, legal, technological and market changes that will be required to mitigate and adapt to climate change. Physical risk relates to physical impacts of climate change (such as those arising from extreme weather events or changes in rainfall patterns). The proposal in this paper addresses primarily transition risk.

4.0 OTHER OPTIONS CONSIDERED

4.1 Not relevant for this report.

5.0 CONSULTATION

5.1 The ongoing development of the climate risk strategy takes place under the auspices of MPF's Investment Monitoring Working Party and has included participation from Members, Officers, TU representatives and external Fund Advisers.

6.0 OUTSTANDING PREVIOUSLY APPROVED ACTIONS

6.1 Pensions Committee has previously approved the planning of a reduction in the climate risk exposure of the passive equities portfolio of MPF.

7.0 IMPLICATIONS FOR VOLUNTARY, COMMUNITY AND FAITH GROUPS

7.1 There are no implications arising directly from this report.

8.0 RESOURCE IMPLICATIONS: FINANCIAL; IT; STAFFING; AND ASSETS

8.1 There may be an increase in investment management costs for the Merseyside Pension Fund arising directly from this report.

9.0 LEGAL IMPLICATIONS

9.1 There are no implications arising directly from this report.

10.0 EQUALITIES IMPLICATIONS

10.1 Has the potential impact of your proposal(s) been reviewed with regard to equality?

(b) No because there is no relevance to equality.

11.0 CARBON REDUCTION AND ENVIRONMENTAL IMPLICATIONS

11.1 The proposal will reduce the investment portfolio carbon foot-print of Merseyside Pension Fund.

12.0 PLANNING AND COMMUNITY SAFETY IMPLICATIONS

12.1 There are no planning or community safety implications arising from this report.

13.0 RECOMMENDATION/S

13.1 That Members approve the proposal to allocate one-third of MPF's passive equities to a low carbon index.

14.0 REASON/S FOR RECOMMENDATION/S

14.1 The recommendation will progress the implementation of a decarbonisation plan that is in line with agreed policies on addressing climate risk with respect to the Merseyside Pension Fund.

REPORT AUTHOR: Owen Thorne

Portfolio Manager (Monitoring & Responsible Investment)

telephone (0151) 242 1301

email owenthorne@wirral.gov.uk

APPENDICES

1. *Greenhouse Gas Risk in the Merseyside Pension Fund Portfolio*, report of Rohan Worrall (Independent Adviser to MPF & member of the IMWP)
2. *Climate Change Investment Policy Framework*, Local Authority Pension Fund Forum (LAPFF), November 2017

BACKGROUND PAPERS/REFERENCE MATERIAL

MPF's Climate Risk Strategy Statement:

<https://mpfmembers.org.uk/content/climate-change>

SUBJECT HISTORY (last 3 years)

	Date
Pensions Committee: Climate Risk Options	March 2016
Pensions Committee: Climate Risk	November 2015