Shropshire County Pension Fund (the “Fund”)

Climate Related Target

This paper provides a statement from Aon, the Fund’s investment advisor, regarding its recommendation for a climate related target

Introduction

The Fund has made significant progress to date in ensuring the risks associated with climate change are considered in its investment strategy. The Fund’s current approach is summarised as follows;

- Identify the risk of climate change.
- Mitigate the risk through ensuring managers integrate environmental, social and governance (ESG) considerations into their investment decisions.
- Further mitigate the risk using engagement with companies.
- Monitor the risk of climate change within the current strategy.

We note that the Council and other stakeholders and campaign groups are requesting the Fund disinvest from Fossil fuels within three years from July 2020. We believe putting in place a target of net zero carbon emissions by 2050 or sooner is a more effective and thorough way to manage climate risk. This is because:

1) Net zero goes beyond emissions from fossil fuel production alone.
2) Net zero aligns with LGPS Central’s approach to implementing the Fund’s investment strategy.
3) Net zero aligns with global industry standards.
4) Net zero allows the Fund to retain influence to engage and encourage positive change from the highest emitters.

Why bring you this note?

To provide a recommendation regarding a climate related target for Shropshire County Pension Fund.

The note provides an introduction, explains the reasoning behind the recommendation and provides next steps.

Recommendation

We recommend the Shropshire Council Pension Fund adopts a net zero carbon emissions by 2050 or sooner target as an effective and thorough way to manage climate risk.

Prepared for: Shropshire County Pension Fund
Prepared by: Aon
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Each of these areas is expanded upon in the next section of this paper. In terms of next steps, we recommend:

1) The Fund should put in place short and medium-term plans to make progress to the net zero by 2050 or sooner target.
2) The Fund should transition out of its UK equity allocation and invest with global sustainable equity manager(s) with LGPS Central.
3) The Fund should transition out of its passive FTSE Developed index allocation with Legal & General (L&G) and invest into the Solactive L&G Low Carbon Transition Global Index.
4) The Fund should continue to work with LGPS Central to put in place the net zero target and short and medium-term plans.
5) The Fund should continue to implement climate stewardship activity, including conveying policies and targets to stakeholders.

Aon, Shropshire County Pension Fund’s investment advisor, recommends that adopting a net zero carbon emissions by 2050 or sooner target is appropriate for the Shropshire County Pension Fund

A number of climate-related targets have been considered for the Fund, including no investments in fossil fuels by 2022 and setting a net zero carbon emissions target by 2050.

We believe setting a net zero target is the most appropriate as a means of decarbonising the Fund’s investment strategy, managing climate risk and ensuring that the Fund keeps pace with the transition to a low carbon economy. This for the following four reasons:

1) Net zero goes beyond emissions from fossil fuel production alone.

Divestment does not resolve the issue of emissions from the end users of fossil fuels. In other words, it does not reduce the demand for fossil fuels from other companies, who themselves have significant carbon emissions that need to be reduced.

Sectors such as utilities, industrials and materials are some of the largest consumers of fossil fuels globally. According to the Fund’s climate risk analysis, many of the largest emitting companies are within the utility sector, rather than being fossil fuel production companies. By progressing with divestment from fossil fuels alone, these sectors would be neglected, despite their relatively high carbon emissions.

Setting a net zero target would see the Fund’s asset managers engage with all high emitting companies, including and beyond fossil fuel companies, to reduce their carbon footprint. This should result in a reduction in overall demand for fossil fuels which is key to mitigating the overall climate risk to the Fund’s assets and the planet’s overall warming pathway.

2) Net zero aligns with LGPS Central’s approach to implementing the Fund’s investment strategy.

The Fund is required to implement its investment strategy using LGPS Central. LGPS Central have confirmed they will be setting a target of reaching net zero by 2050, meaning its underlying investment offerings will be aligned with this policy. As such, implementing a net zero target can be done, both through the investments the Fund currently holds with Central and will be embedded in future investment options considered.

3) Net zero aligns with global industry standards.

The Glasgow Financial Alliance for Net Zero acknowledged in its *progress and plan towards a net-zero global economy*, published in November 2021, that divestment could lead to real-world emissions increasing as a result of carbon-intensive assets moving from those with an objective to improve operations, to those without. The UN-Convened Net-Zero Asset Owner Alliance are also aligned to this belief, stating that divestment *“does not achieve the objective of protecting investee businesses or broader society from the worst effects of climate change or contributing to the wider* *transformation needed to limit global warming to 1.5C”*. Both cite engagement as the most effective method of reaching such targets.

This also aligns with other bodies such as the Institutional Investors Group on Climate Change (IIGCC) and the Net Zero Asset Managers Initiative.

The UK Chancellor, Rishi Sunak, announced at COP26 new requirements for firms to publish net zero transition plans setting out decarbonisation through to 2050. This illustrates the direction of travel amongst global financial markets.

4) **Net zero allows the Fund to retain influence to engage and encourage positive change from the highest emitters.**

Climate change risk management requires cooperation between various actors. Companies need to be incentivised to adapt and the encouragement from shareholders and providers of capital can be a powerful tool to accelerate change.

Therefore, by not divesting, the Fund is able to retain influence by engaging with companies, rather than watching from the side-line. By choosing to divest, the Fund would be passing the responsibility to an alternative investor. The alternative investor may be less concerned about the transition to a low carbon economy, and therefore apply less scrutiny to the company.

The Department for Work and Pensions is also clear on the potential value of engagement, in the 21 October open consultation on climate and investment reporting, it states *“It should be noted that Government continues to believe blanket divestment from certain assets is the wrong approach – engagement with high-carbon companies, when done effectively, can reduce the climate risk to which the scheme is exposed.”*

In conclusion, Aon recommends that adopting a net zero carbon emissions by 2050 or sooner target is an effective and thorough way for the Shropshire County Pension fund to manage climate risk.

Next Steps

We will provide the Fund with advice and support on each of the next steps identified, but for brevity they are summarised here.

1) The Fund should put in place short and medium-term plans to make progress to the net zero by 2050 or sooner target.

The Fund should recognise that the transition to net zero will not be linear, but should set short, medium and long-term goals towards meeting the net zero expectations. For example, halving emissions by 2030, in line with the IIGCC net zero framework.

2) The Fund should transition out of its UK equity allocation and invest with global sustainable equity manager(s) with LGPS Central~~.~~

The Fund should replace its UK equity allocation, which is around 6% of total Fund assets, with actively managed global sustainable equity fund(s) now available to be implemented through with LGPS Central.

This change will not affect the Fund’s expected risk and return characteristics but will reduce the carbon footprint of the portfolio by allocating investment in companies which focus on sustainable business and which may contribute to the transition to a low carbon economy.

3) The Fund should transition out of its passive FTSE Developed index allocation with Legal & General (L&G) and invest into the Solactive L&G Low Carbon Transition Global Index.

The Fund should replace its global market cap passive allocation, which is around 30% of total Fund assets, with an investment in the Solactive L&G Low Carbon Transition Global Index.

The new passive benchmark will deliver meaningful carbon exposure reduction and a positive tilt towards companies with green revenues. Typical carbon emissions reduction ranges between 40-60% when compared with the market cap parent benchmark with a further 7% each subsequent year to reach net-zero by 2050.

This change will not affect the Fund’s expected risk and return characteristics but will significantly reduce the carbon footprint of the portfolio.

4) The Fund should continue to work with LGPS Central to put in place the net zero target and short and medium-term plans.

The Fund should encourage Central to formalise its own net zero targets and work with them to put in place short, medium and long-term plans.

5) The Fund should continue to implement climate stewardship activity, including conveying policies and targets to stakeholders.

The Fund should continue to liaise with appointed asset managers and service providers to engage in line with the Fund’s climate stewardship plan and climate stewardship policy.

Furthermore, when the net zero and interim targets are finalised, the Fund should convey the climate related expectations and requirements in line with the Fund’s objectives, monitoring and engaging on these as necessary.

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