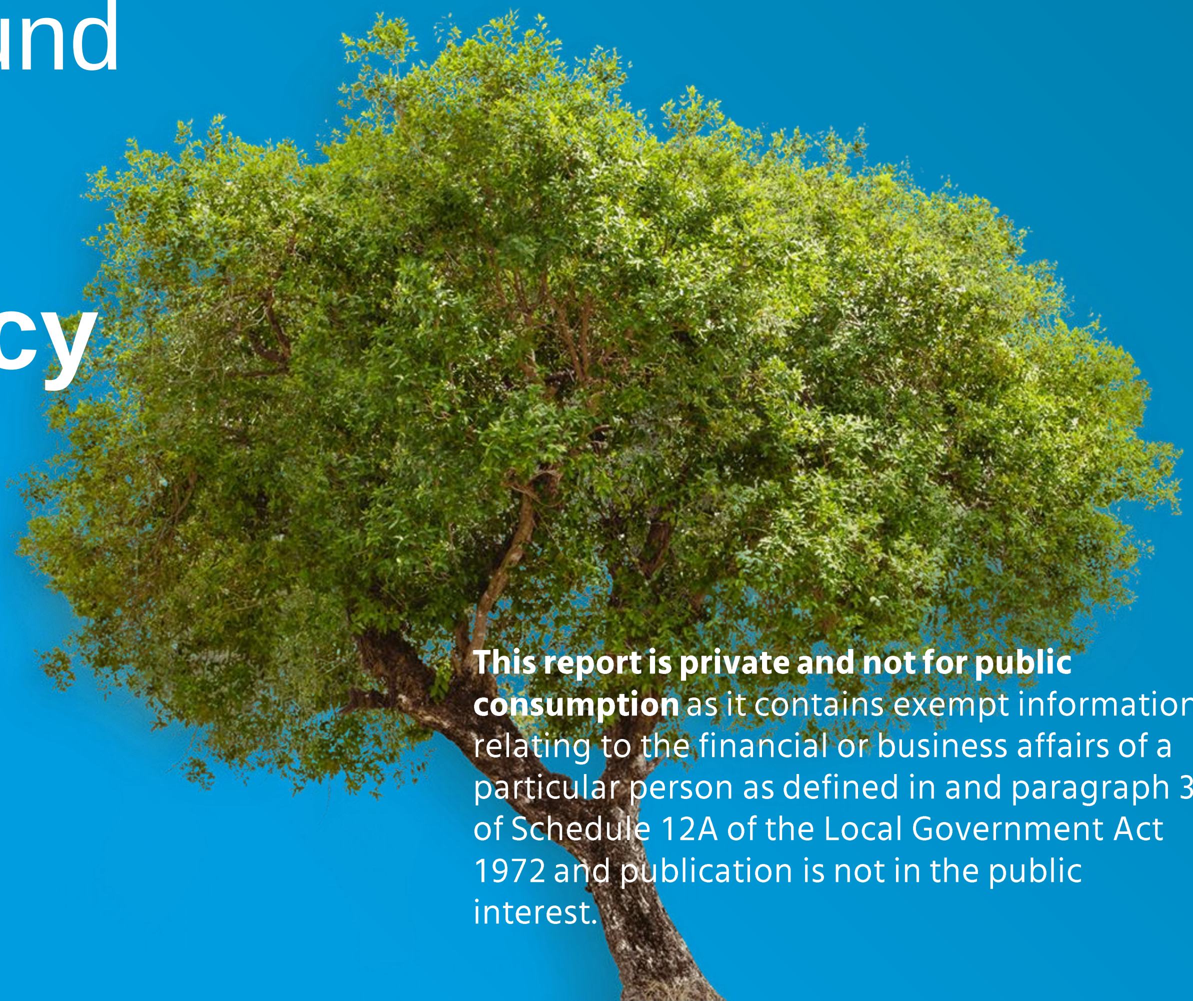
Mercer

London Borough of Croydon Pension Fund

ESG Policy



September 2021

Peter Gent FIA

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welcome to brighter

Introduction

This report is addressed to the Pensions Committee (“the Committee”) of the London Borough of Croydon Pension Fund (“the Fund”)

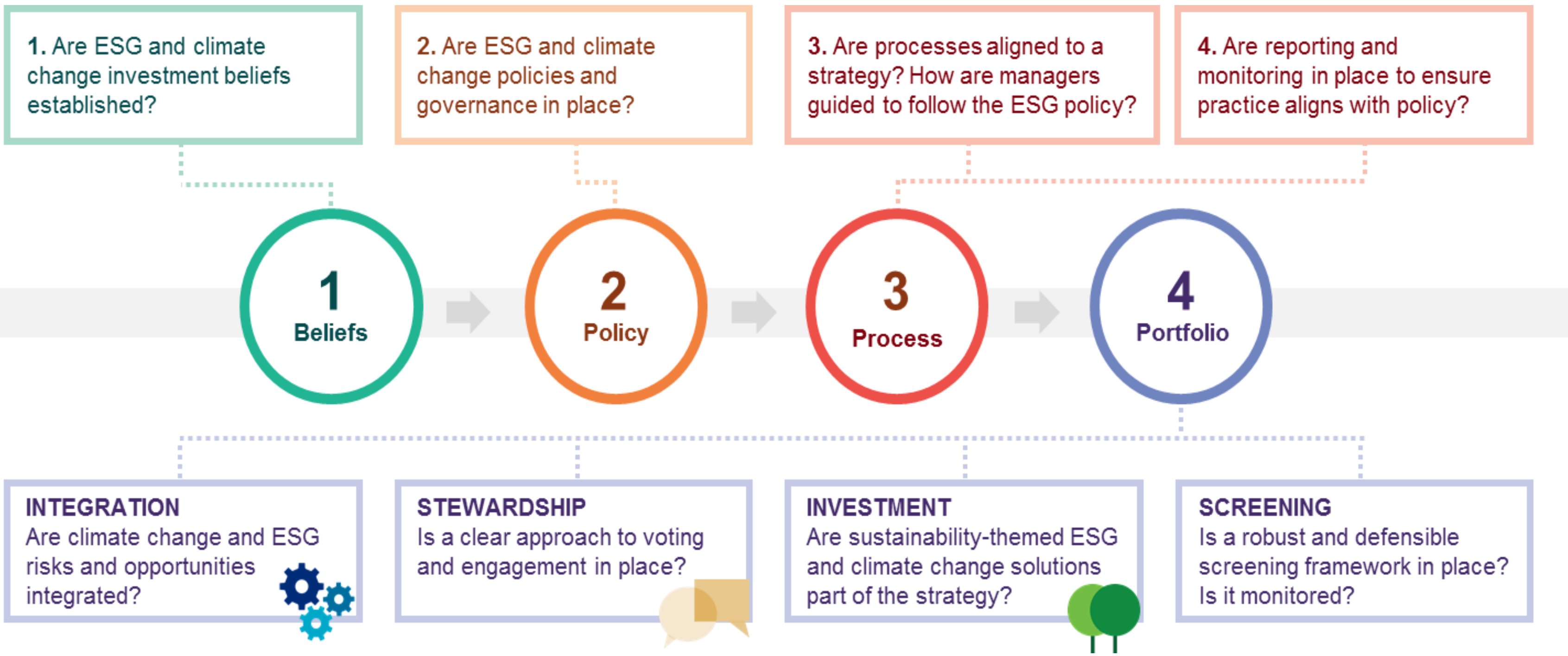
The Committee’s beliefs on Environmental, Social and Governance (‘ESG’) considerations are well defined.

The policy approach to ESG is formally set-out in the Fund’s Investment Strategy Statement (‘ISS’). Since this part of the ISS was last updated, there have been significant changes in terms of approach to measuring ESG integration and implementation options via the London CIV (‘LCIV’).

The purpose of this paper (in conjunction with the Officer paper) is to re-visit the Fund’s ESG policy and assess if there are any amendments that can be made to reflect the industry wide evolution of approach on ESG integration.

Once the ESG policy has been agreed, the Committee can start to measure and evolve the portfolio (including a review of the equity portfolio at the Q4 2021 meeting) in-line with best practice.

Responsible Investment
Framework for ESG integration



Fund's Current Policy

*The Fund will only invest in investments with a **strong environmental, social and governance policy that includes no tobacco investments**. The **Fund will disinvest from existing fossil fuel investments** in a prudent and sensible way that reflects the fiduciary responsibility due to stakeholders. Furthermore, where this is consistent with the agreed investment strategy, the Fund will invest in assets that positively address these issues. Examples of this approach include investing in renewable energy projects, screening out regional markets where there might be issues with modern slavery, and looking to explore opportunities to contribute to and invest in the Borough.*

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Setting targets
Be aware of unintended consequences

- Understand your metrics
- Balance with other pension and investment risks
- Be flexible to new data and approaches
- Divestment is a tool not the answer
- Look for opportunities
- Set the baseline year

"Merely selling your stocks that make you look bad from a fossil fuels standpoint is a reverse greenwashing because it doesn't actually fix the problem" Guy Opperman, Pensions Minister

Climate change risk
Fossil fuel divestment vs carbon management

		A	B	C
	MSCI ACWI - Global Index	ACWI ex-Fossil Fuels	ACWI Low Carbon Leaders	ACWI Low-Carbon Target
	Parent Index	An alternative	An alternative	An alternative
Carbon Intensity (company specific direct and indirect emissions)	100	-17%	-51%	**-80%**
Potential Carbon Emissions (carbon reserves)	100	-100%	-66%	**-97%**
Coal Reserves (% index weight)	0.9%	0.0%	0.3%	**0.0%**
Fossil Fuel Reserves (% index weight)	6.5%	0.0%	4.8%	**1.2%**

Source: MSCI

A

"… broad market while excluding companies that own oil, gas and coal reserves… "

B

"… two dimensions of carbon exposure – carbon emissions and fossil fuel reserves – an effective tool for limiting the exposure to carbon risk… "

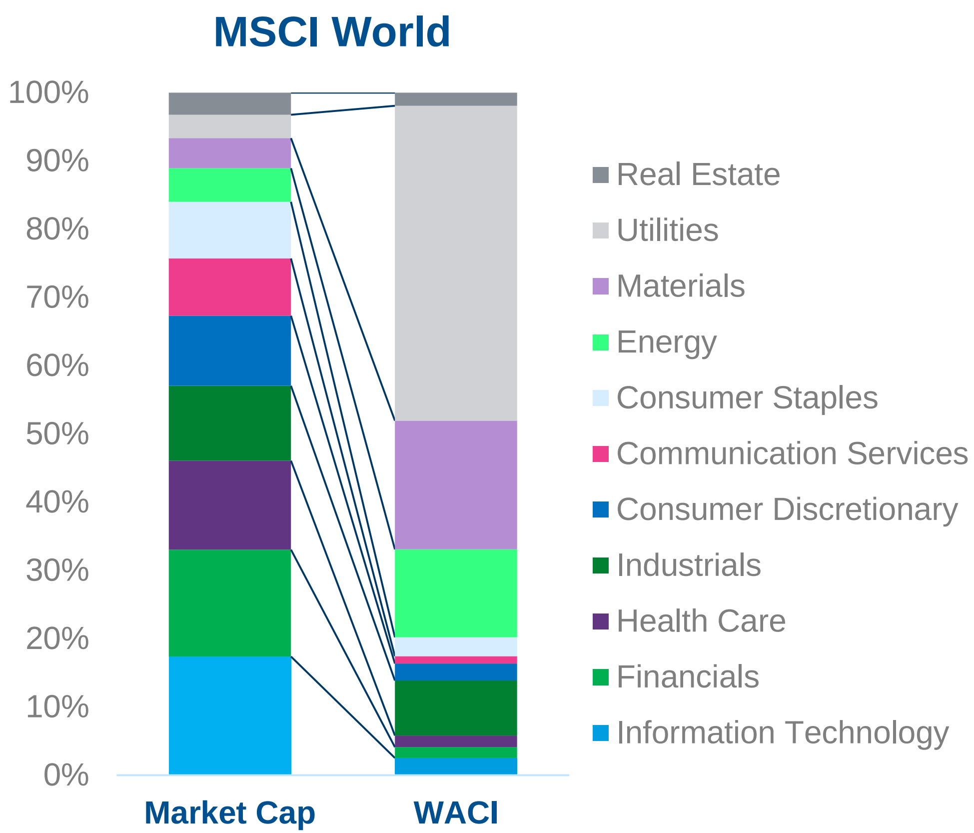
C

"… a benchmark for investors who wish to manage potential risks associated with the transition to a low carbon economy – a tracking error target of 0.3% (30 basis points)… "

A focus on reducing carbon emissions across the portfolio (as opposed to divestment from fossil fuels) is now possible and gives a more robust approach to managing climate change risk and allows the Committee to investigate timescales to achieving net-carbon neutrality. A strategy focused on carbon will include divestment from some fossil fuel companies.

Climate change risk
Fossil fuel divestment vs carbon management

There are substantial differences between emissions from different sectors. Relatively small sectors like Utilities, Materials and Energy are (not surprisingly) relatively high emitters compared to their weight in indices.



Climate Change Risk
An alternative route

Measure carbon intensity of portfolio and integrate carbon intensity when building equity portfolio (along with other investment risks)

+

Report in line with TCFD* (in advance of regulatory requirement to do so)

+

Undertake climate change scenario analysis and investigate time scale feasibility of net zero target

* See previous training session

Broad ESG Integration
An alternative route

ESG ratings are undertaken by Mercer's global manager research team. They are on a scale from 1 (highest) to 4 (lowest) and assess how well managers integrate ESG factors into investment processes.

ACTIVE

ESG 1
Leading approach to integration, where ESG is **embedded in investment philosophy;** strong on stewardship which is a core part of process

ESG 2
Consistent and repeatable process to ESG integration (**focus on risk management**); well-developed evidence of stewardship.

ESG 3
Well-developed G integration; less consistency in E&S stewardship process is ad hoc, but indications of progress.

ESG 4
Little or no integration of ESG factors or stewardship into core processes and no indication of future change.

Ratings for passive equity strategies differentiate how well firms undertake their stewardship activities such as voting, engagement, industry collaboration and reporting.

PASSIVE

ESGp 1
Leaders in V&E **across ESG**; stewardship activities and ESG initiatives undertaken consistently at a **global level; clear link between engagement & voting actions**

ESGp 2
Strong approach to V&E across ESG topics, and initiatives at a regional level, with progress made at a global level; **working towards clearer links between V & E**

ESGp 3
Focus of V&E tends to be on **governance topics only**, or more regionally focused with **less evidence of E&S** (in voting & engagement, as well as other internal ESG initiatives)

ESGp 4
Little or no initiatives taken on developing a global V&E capability, reactive engagements; and little progress made on other ESG initiatives

Allow LCIV and managers to integrate ESG requirements on Fund's behalf with appropriate level of engagement and oversight.

Conclusion and next steps

We support an evolution of approach to a more holistic integration of ESG considerations by the Fund. This would include:

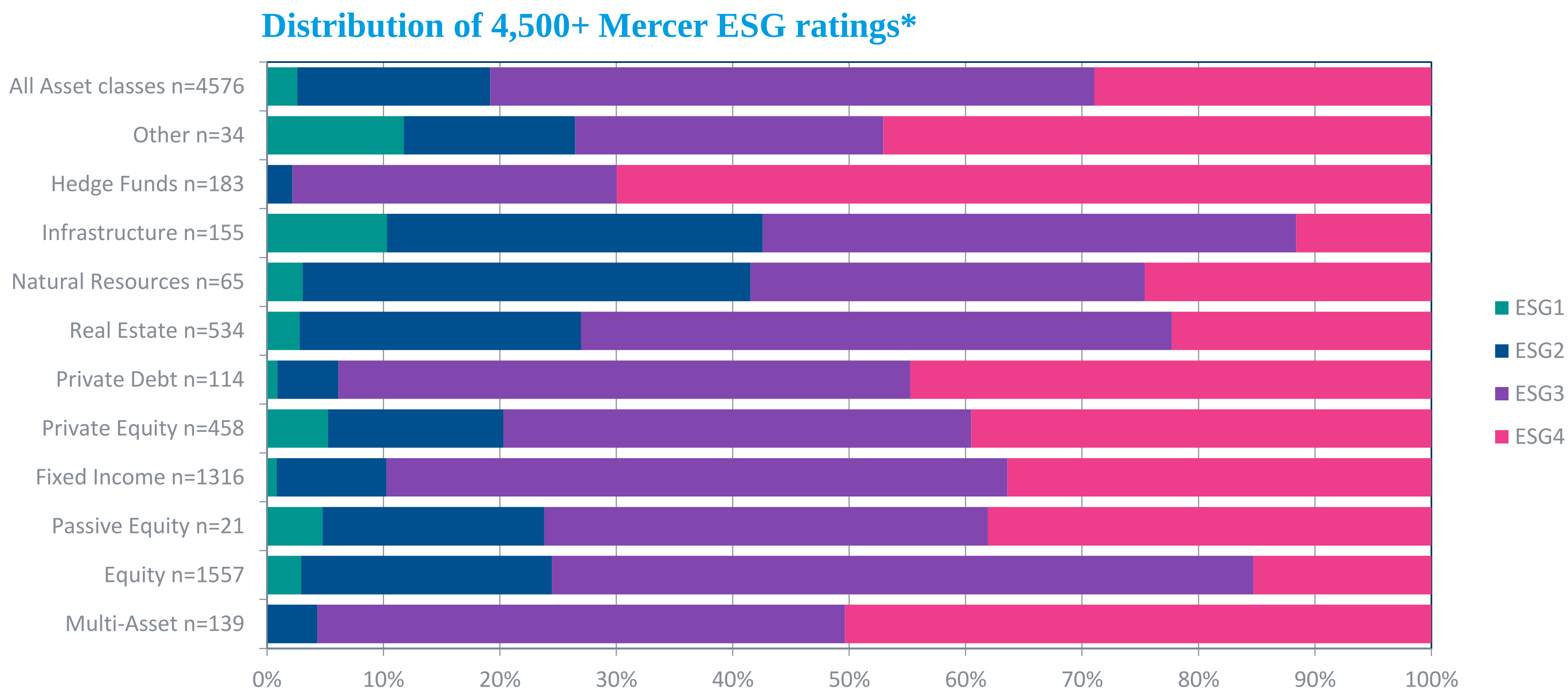
- A focus on managing carbon intensity rather than solely divestment of fossil fuels
- Investigate decarbonisation timescales
- Allowing concessions to LCIV (and their chosen mangers) to manager broader ESG issues with the appropriate level of engagement and measurement (e.g. ongoing carbon intensity and measurement of tobacco holdings)
- Focus on engagement and stewardship to ensure effective implementation and measurement of ESG issues
- Update reporting in line with best practice including TCFD

The immediate next steps are as follows:

- Update the ESG policy statement in the ISS based on the wording set out in the Officer paper
- Use the current portfolio as a baseline and review the equity managers at the next meeting in-line with the revised policy (and broader investment risk considerations)
- Update reporting and draft TCFD report for consideration by the Committee
- Investigate timescale of targeting a net-carbon-zero position
- Review and refine approach to ESG in-line with current best practice

Appendix

Mercer's ESG Ratings By Asset Class



Over **4,500** strategies rated currently – ratings began in **2008**

Approximately **19%** achieve an **ESG1** or **ESG2** rating

ESG ratings for passive equity introduced in **2014**

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ESGp ratings for passive equity are applied at manager level and are not included in the total strategy count
ESG ratings on sub-advised strategies are also excluded from the total to avoid double counting
"All Other" predominantly includes multi-asset strategies
**Analysis as at March 2020

11

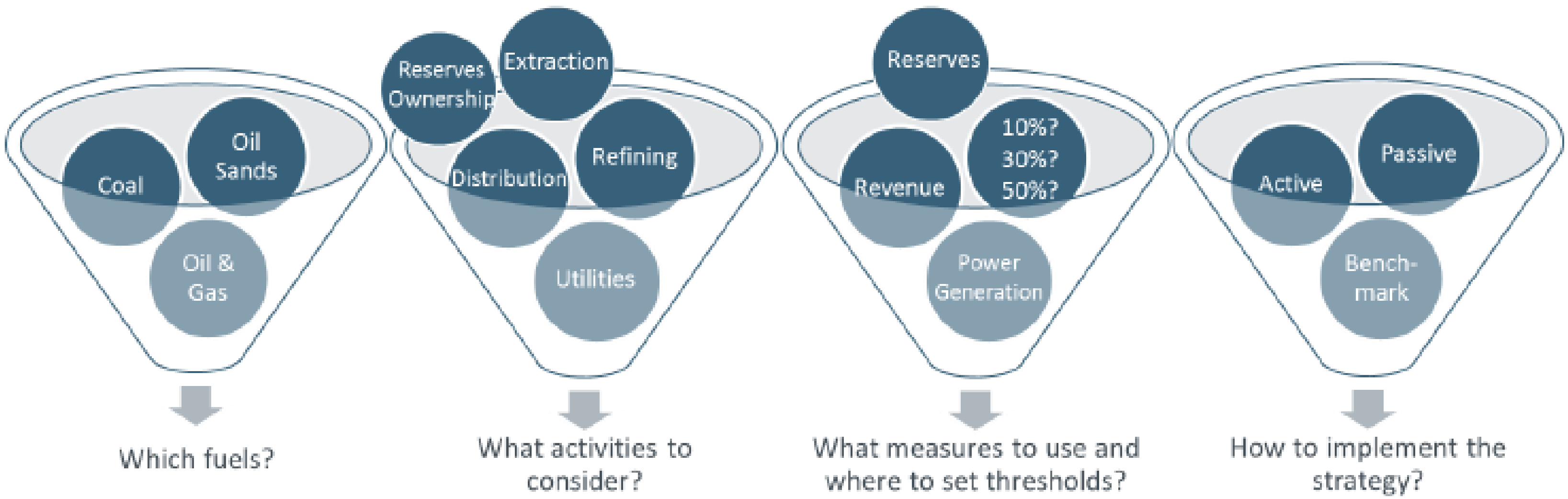
What does Divestment from Fossil Fuel mean?

While ‘Divestment’ may sound simple as an investment approach, in practice it is complex and there are a number of definitions used across the industry. In addition, while used widely, the term ‘Fossil Free’ is not consistently defined.

Broad class	Description
Full Divestment	Binding commitment to divest (direct ownership, pooled funds, shares, corporate bonds or any other asset classes) from any fossil fuel company (coal, oil, gas, unconventional) - any tie
Partial Divestment	Binding commitment to divest across asset classes from some fossil fuel companies (coal, oil, gas, unconventional); or to divest from all fossil fuel companies (coal, oil, gas, unconventional) but only in specifc asset classes (direct investments, domestic equity) or using a defined treshold
Fossil Free	Resulting from full divestment and commitment to avoid any fossil fuel investment in the future

Focus of divestment is on “fossil fuel companies” - those companies that own fossil fuel reserves (potential emissions)

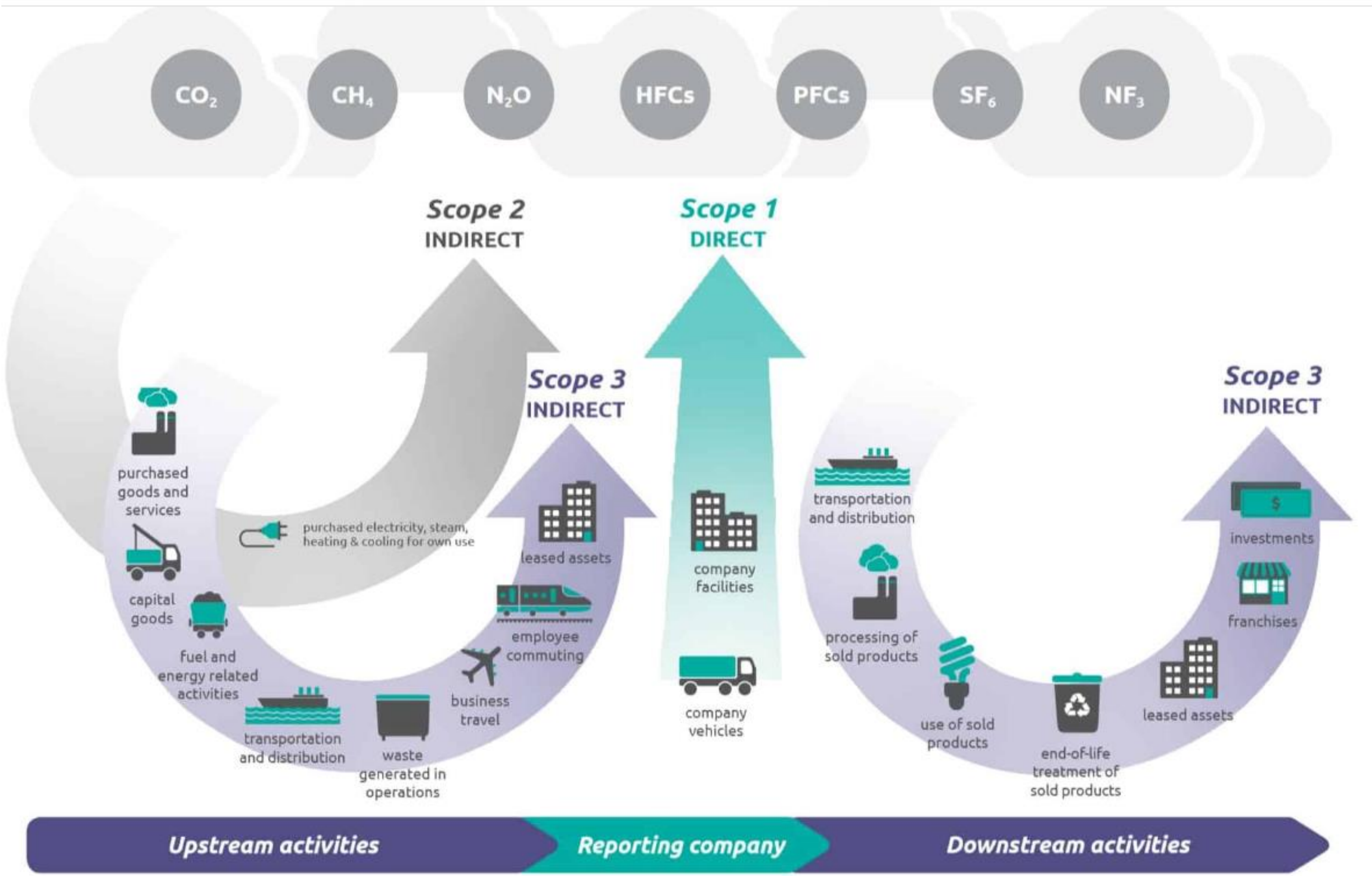
Divestment Implementation
Questions to ask



FURTHERMORE, WHICH ASSET CLASSES?

SOURCE: MSCI

Carbon footprinting
Scope 1, 2 and 3 emissions



Source: compareyourfootprint.com

TCFD Reporting Best Practice
Regulators Direction of Travel

Governance

- Review **climate change-related investment beliefs**
- Establish processes to gain comfort that managers are assessing and managing climate-related risks and opportunities
- **Regular climate training**

Strategy

- Conduct **climate change scenario analysis** to understand the impact on assets/liabilities
- **Stewardship** included in the strategy, with a focus on policy and industry engagement, including collaborative and climate change initiatives

Risk Management

- Include climate change risk within the **risk register**
- Include climate change considerations as part of the **selection and monitoring of managers**, with a particular focus on integrating/voting/engaging on climate change
- **Annual review of manager ESG ratings** alongside other climate change data
- Consider sustainable asset allocations

Metrics and Targets

- Align with best practice approaches, in terms of metrics to measure risk and opportunity
- Carry out **carbon foot-printing** on equity and corporate bond portfolios.
- Consider **non-emissions based metrics**, such as green revenues.
- Consider what target(s) can be set to manage climate-related risks.

UK Stewardship Code 2020

Principles for asset owners and asset managers

1 **Purpose, investment beliefs, strategy and culture** enable stewardship that creates long-term value for clients and beneficiaries.

2 **Governance, resources and incentives** support stewardship.

3 Manage **conflicts of interest** to put best interests of clients and beneficiaries first.

4 Identify and respond to market-wide and systemic risks to **promote a well-functioning financial system.**

5 **Review stewardship policies,** review processes and assess the effectiveness of activities.

6 Take **account of client and beneficiary needs** and communicate the activities and outcomes of stewardship and investment.

7 Systematically **integrate stewardship and investment**, including material ESG issues, and climate change to fulfil responsibilities.

8 **Monitor and hold account** managers and/or service providers

9 **Engage with issuers** to maintain or enhance the value of assets

10 Participate in **collaborative engagement** to influence issuers.

11 **Escalate stewardship activities** to influence issuers where necessary.

12 Actively exercise **rights and responsibilities**

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