

Briefing

Local government pensions: fossil fuel divestment

UK local authority pension funds hold investments of over £16 billion in coal, oil and gas companies¹. These companies' actions are making climate change worse, threatening all of our futures (see page 2).

There are ethical and financial reasons for these local authorities to sell ("divest") their pension holdings in these fossil-fuel companies.

Divestment is happening. In the last two years, 6 UK local authorities or Government Agencies have taken various divestment actions: South Yorkshire, Waltham Forest, the Environment Agency, Southwark, Haringey and Hackney (see page 5).

They join a snow-balling number of institutions globally who are divesting – as of November 2017 830 institutions, whose assets total over \$6 trillion², have made divestment commitments. This January, the mammoth \$189 billion New York City state pension fund announced it would divest its \$5 billion fossil fuel holdings³.

This briefing covers five issues which come up in discussions around local authority divestment:

- 1) The ethical arguments for divestment**
- 2) The financial reasons for divestment**
- 3) The practicalities – who is divesting?**
- 4) The practicalities – what can local authorities invest in instead?**
- 5) How to respond to authorities who want to "engage" with fossil fuel companies instead of divesting**

1) The ethical arguments for divestment

We have already seen global warming of over 1 degree centigrade⁴. The resulting climate change⁵ is now leading to increasingly severe impacts – from rapidly melting sea-ice at the poles⁶ and 50 degree heatwaves in India⁷, to floods in Louisiana⁸ and drought in California⁹. The UK is seeing worse impacts too – with increasingly severe flooding¹⁰ in almost every region and country in the UK in recent years. These impacts will get worse, because we are currently on track for a three-degree warming world¹¹. For example according to the World Bank a 3 degree warming world would see 113 “heat-wave days” a year in Baghdad, compared with 47 such days a year in a 1.5 degree world¹².

Why fossil fuel companies’ actions are making climate change worse:

- At Paris in December 2015, 196 nations agreed to hold global warming to “well below 2 degrees” , and to “pursue efforts to limit the temperature increase to 1.5 degrees”¹³;
- The UK Government said in December 2016 that “70-75 percent of known fossil fuels would have to be left unused in order to have a 50% chance of limiting global temperature rise to below 2°C”¹⁴;
- The Governor of the Bank of England has said that the action needed to keep to a 2 degree goal “would render the vast majority of [existing] reserves “stranded” – oil, gas and coal that will be literally unburnable”¹⁵;
- Yet, fossil fuel companies are actively drilling for NEW reserves of coal, oil and gas over and above existing reserves; their actions are completely incompatible with staying within 2 degrees¹⁶.

“Lack of action on climate change threatens to make the world our children inherit a completely different world than we are living in today. Climate change is one of the single biggest challenges facing development, and we need to assume the moral responsibility to take action on behalf of future generations, especially the poorest”

Jim Yong Kim

World Bank President, 2012

The consequences for pension funds:

Pensions are for our future security. Climate change is one of the biggest threats to that security. On ethical grounds, pension funds should not invest in companies who are making climate change worse.

2) The financial reasons for divestment

Pension fund boards have a “fiduciary duty” – to act in the best interests of the funds beneficiaries. This section sets out how “best interests” means pension funds now need to assess and act on climate risks.

Increasingly, Governments are taking stronger action on climate change. There are bumps in the road, but the direction of travel is one-way: action will increase. More and more fossil fuel “assets” will become stranded as Governments legislate on climate change and raise the price of carbon. The Paris Agreement¹⁷ in December 2015 is the clearest signal yet.

The Governor of the Bank of England¹⁸ is just the latest in a long line of financial heavyweights¹⁹ noting the increasing risk that fossil fuel companies are overvalued, in a world where greater action on climate is inevitable. As yet these risks have not yet been properly assessed or priced by financial regulators or the fossil fuel companies:

- Impax Asset Management say: *“there are strong indications that today’s prices of energy stocks do not account for the risk”* of Government intervention to reduce fossil fuel pollution²⁰;
- Investment experts Mercers consider climate change: *“A new investment risk that demands action by investors”*²¹;
- S&P Dow Jones Indices said in October 2015 on stranded assets that *“while the moral argument is compelling, there is strong evidence that the financial risks cannot be discounted either”*²².

Reaction to the December 2015 Paris Climate Agreement:

“Change is likely to be swift as pension funds recognise their fiduciary duty to address climate risk in all parts of their portfolios and, where necessary, to reallocate investment away from high carbon-related activity likely to destroy substantial shareholder value in a remarkably short time.”

Donald MacDonald, chair of the Institutional Investors Group on Climate Change, and trustee director of BT Pension Scheme

Some commentators argue that there will not be stranded assets because Governments won’t tackle climate change²³. Pledges of action have increased recently. These pledges are not yet sufficient - current estimates are that climate pledges if met would lead to around 3 degrees warming - but analysis by Carbon Tracker highlights that even if warming went as high as 3 degrees, listed companies still could not burn all their existing reserves²⁴. So even with current and so far inadequate pledges, companies can’t burn all their reserves, and assets will be stranded.

Pension funds need to be more aware that above 2 degrees warming, the damage to the global economy from climate impacts will be increasingly unmanageable, and will damage the majority of assets in a pension fund portfolio. Business-as-usual is a highly damaging scenario for pension funds.

The tide is turning away from fossil fuels

Government actions on the environment are one of the reasons for falling fossil fuel company share prices in recent years – for example falling global coal demand due in part to Chinese Government action to reduce chronic air pollution in Chinese cities.

The cost of renewable energy has rapidly declined, continues to fall, and in many countries matches or out-competes fossil fuels on price²⁵. In 2016 global renewables investment was \$300 billion, double that for fossil fuels²⁶. Many economists forecast that fossil fuel assets will become stranded as the price of renewables continues to fall²⁷, and other developments, such as electric vehicle deployment, continue their exponential growth. Transitions to new technologies can occur very quickly and are seldom predicted by the mainstream financial market.

These three factors – regulation to limit carbon emissions, the increasing competitiveness of renewables, and the growth of new technologies – are driving an acceleration in the switch from fossil fuels to renewable energy. Combined, they pose a growing risk to fossil fuel investments.

Fiduciary duty means pension funds should assess the financial risks due to climate change of their current exposure to the fossil fuel sector.

A couple of years ago some funds argued that they could not divest, because their “fiduciary duty” meant they had to ignore so-called “ethical” issues. They were wrong, ethical issues can be considered. But in addition, the evidence is increasingly clear that to be compliant with fiduciary duty the financial risks of the fund’s exposure to the fossil fuel sector must also be assessed.

“Fiduciary duty” is rightly and legally a core concern for pension funds. But LGPS legal advice²⁸ and Law Commission guidance²⁹ say **fiduciary duty rules do allow pension funds to consider ethical factors in investment decisions, so long as these do not negatively affect financial performance, and are not contrary to members’ wishes**. And there are many ways in which divestment from fossil fuels can be done without negatively affecting financial performance (see Section 4).

A December 2016 legal opinion for ClientEarth from two leading UK barristers found that pension fund trustees who fail to consider climate risk could be exposing themselves to legal challenge³⁰. In addition to the dangers for laggards, Impax Asset Management outline the advantages for early-movers: *“In time, it is likely that the market values of all stocks will incorporate carbon risk. However, investors who*

The Environment Agency, on its decision to decarbonise its equity portfolio:

“The Fund’s fiduciary duty is to act in the best long-term interest of our members and to do so requires us to recognise that environmental, social and governance (ESG) issues can adversely impact on the Fund’s financial performance and should be taken into account in the funding and investment strategies and throughout the funding and investment decision making process.”

position themselves ahead of this change should out-perform”³¹.

Climate change is also a growing risk to all society, not just individual pension funds. If pension funds are not addressing these risks, they are arguably complicit in seeing those risks increase.

Even if your pension fund refuses to act on ethical, security grounds, it should be taking action on financial grounds, given the increasing risks posed by holding high-carbon investments.

3) The practicalities – who is divesting?

These theoretical arguments are backed-up by practice: pension funds have started to divest from fossil fuels already:

- In October 2015, the £2.9 billion **Environment Agency Pension Fund** said it would divest 90% of its coal assets and 50% of its oil and gas stocks by 2020, saying this was in line with keeping below 2 degrees, and meeting the fund’s fiduciary duties³²;
- In November 2015, **South Yorkshire** Pension Fund announced it would divest from companies focussed on coal and tar sands³³;
- **Haringey** pension fund moved £200 million into the MSCI World Low Carbon Target Index Fund in January 2016³⁴;
- in September 2016, Conservative and Labour councillors in **Waltham Forest** unanimously voted to divest the pension fund from fossil fuels within 5 years³⁵;
- in December 2016, **Southwark** pension fund announced it would divest from fossil fuels³⁶.
- In February 2017, **Hackney** pension fund announced it would cut exposure to fossil fuel equity investments by 50% over the next 6 years, following a carbon risk audit by Trucost in Summer 2016³⁷.

Other institutions are increasingly pulling out of fossil fuels. In May 2017 investment firm BMO announced they would divest their entire “responsible” range from fossil fuels by 2020³⁸. BMO manage the ethical option for NEST – the UK’s 3 million member auto-enrollment workplace pension scheme. Europe’s largest insurer Allianz SE pulled out of coal in November 2015, joining California’s largest pension funds and the Norwegian Sovereign Wealth Fund³⁹; Over 50 UK academic institutions have made fossil-fuel divestment commitments⁴⁰, the British Medical Association has divested from fossil fuels⁴¹ and the Church of England has divested from coal and tar sands⁴². In October 2017, 40 Catholic institutions globally announced they would divest⁴³. The Trades Union Congress backed fossil fuel divestment in Sept 2017⁴⁴, and council employees UNISON backed local authority pension fund divestment in June 2017⁴⁵. More than 50 MPs support a new campaign for the parliament’s pension fund to divest from fossil fuels⁴⁶. In Jan 2018, New York City announced fossil-fuel divestment⁴⁷.

4) The practicalities – what can local authorities invest in instead?

Divesting from fossil fuel companies should not negatively affect the financial performance of funds.

Plenty of mainstream alternative investment options exist which have no or very low fossil-fuel investments⁴⁸. Over the last 5 years the fossil fuel-free indices from FTSE, Standard and Poors and MSCI have each out-performed the same index with fossil fuel companies in them:

Annualised return over the last 5 years:

Fossil fuel-free index	Annual return	Standard index	Annual return
MSCI ACWI ex Fossil Fuels Index ⁴⁹	16.35	MSCI ACWI Index	15.12
S&P GLOBAL 1200 FOSSIL FUEL FREE INDEX ⁵⁰	8.97	S&P GLOBAL 1200 ⁵¹	7.45
FTSE All-World ex CW Climate Balanced Factor Index ⁵²	10.2	FTSE All-World	10.1

Of course, past performance is no guarantee for future performance, but these are examples which show there is nothing inherently financially damaging about excluding a particular class of investments.

These types of indices are increasingly being used by big players. In November 2016, Legal and General set up a new lower-carbon index, its Future World Fund⁵³, into which HSBC have invested £1.8 billion. This fund tracks the above FTSE Climate Balanced index.

Haringey council's review of its approach to move away from fossil fuels found in July 2017 that: *"the low carbon approach has secured returns that are very closely correlated to overall market performance (and in fact are slightly higher in the medium term): therefore altering the current investment strategy by increasing the allocation to low carbon, should not adversely affect the Fund's investments"*⁵⁴.

Many organisations which have committed to divest from fossil fuels are happy to share their experience and investment policies with others institutions considering this. Europeans for Divest-Invest⁵⁵ is a consortium of investors that have signed up to divest from fossil fuel assets and invest in 'climate solutions'. It is happy to facilitate introductions or convene roundtables to discuss this further.

Other examples of reinvestment opportunities beyond shifting into low-carbon indices are set out by Community Reinvest⁵⁶.

5) How to respond to authorities who want to “engage” with fossil fuel companies instead

Some pension funds argue that they need to keep their fossil fuel investments, so they can “engage” with companies, to try to persuade them to change their behaviour.

Shareholder engagement can work in some sectors, where the change required does not challenge the companies’ core business model, for example getting a company to remove a certain product from its supply chain.

But engagement does not work well where it’s the company’s core business model which needs to change, such as the coal, oil and gas sector.

In the fossil fuel sector, the evidence shows that engagement has not worked. Shell and BP have passed resolutions, but these relate to monitoring and reporting. These companies still refuse to re-align their business models with a 2 degree world. The results of the 2016 AGM engagement season were particularly disappointing, with analysis that:

- *“Shell downplays the risks that a 1.5 – 2°C outlook poses to its business model and does not provide a clear pathway for strategic alignment with the target set by governments at COP21 in Paris”;* and
- *“BP’s reporting on resilience against low-carbon post-2035 scenarios lacks depth, with the company continuing to doubt the likelihood of a 2°C outcome and forecasting a ‘base case’ of fossil fuel demand consistent with 4 – 6°C warming.”*⁵⁷

At the 2017 AGMs, both these companies have again shown no sign of moving – with investor briefings stating that *“Shell is not committed to a credible <2°C strategy”*⁵⁸ and *“BP is not committed to a credible <2°C strategy”*⁵⁹, and *“Shell’s current business model and base case for planning is consistent with 3-5°C+ of global warming”*⁶⁰.

Shell and BP accept that climate change is a global threat, but still continue to operate under business scenarios that would lead to catastrophic levels of climate change, rather than keeping to below 2 degrees⁶¹. Engagement is not working on companies like Shell and BP, and even if it could, it is distinctly unlikely that UK local authority pension funds could exert adequate influence on them to do so⁶².

It is high-risk to assume that an engagement-only approach with fossil fuel companies will have sufficient traction quickly enough. Engagement also carries greater financial risks than divestment, for if it is not successful, then the exposure to potentially stranded-assets remains.

In contrast, divestment has been successful in the past, for example as part of global efforts aimed at changing the actions of Apartheid South Africa. Divestment helped to increase the

political pressure for action. This is happening now on fossil fuels, with hundreds of institutions worldwide divesting, and more joining every month⁶³.

There are also increasingly moves away from a narrow engagement-only approach, to combining engagement with divestment, for example:

- Pension giant Aviva's climate change strategy sets a clear limit to engagement, and says it will "divest where necessary" if companies have not made adequate progress⁶⁴;
- Carbon Tracker argues that "*true engagement needs the pressure created by divestment. Engagement without divestment is like a criminal legal system without a police force*". Strategies of partial divestment first can be a signal to companies that engagement cannot be dismissed - because it carries with it the potential for further divestment. Engagement with fossil fuel companies is more likely to have a chance of success if divestment is also being pursued;
- Impax Asset Management⁶⁵ recommends "*a reallocation of 30% the holdings of a typical portfolio in oil and coal producers*" and states that "*investors who wish to engage with management teams of fossil fuel asset owners can still do so if they opt for partial re-allocation*";
- Legal and General have also announced they are changing their approach to engagement. They say that they will set deadlines for engagement, and divest from companies who have not made adequate progress⁶⁶;
- A July 2016 LAPFF/CTI report⁶⁷ sets out a checklist of questions for engagement around a 2 degree transition, and concludes: "*the answers to such questions should put shareholders in a position to gauge the risk profile of their investment. There is a financial argument that those that can't reassure investors could be considered as divestment candidates*".
- In November 2017, the Local Authority Pension Fund Forum (LAPFF) issued guidance⁶⁸ to its members saying that suitable approaches for addressing climate change: "*may include active management of carbon risk which results in some reduction of exposure, such as a tilt towards low-carbon companies and assets, alongside company engagement and an increased allocation to low-carbon investment opportunities.*"

Sectors for whom an engagement approach to climate change is more likely to be successful include automobile manufacturers and power utilities – because for both of these there are credible, viable alternative business models being adopted: such as electric vehicles and renewable power. But for fossil fuel exploration and production sector, with the sole exception of the smaller DONG energy, which has successfully transitioned away from oil and gas, all the oil and gas majors have current and future business models overwhelmingly based on fossil fuel extraction, and no prospect of change within the timescales required by the Paris climate agreement goals. Engagement is an unfit strategy for pension funds to use with these fossil fuel exploration and production companies.

Further detail⁶⁹:

For extra materials (infographics, how to campaign guides, case studies etc), see

<https://friendsoftheearth.uk/go/divest>

gofossilfree.org/uk/pensions/

foe.scot/campaign/divestment/

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³ <https://www.nytimes.com/2018/01/10/nyregion/new-york-city-fossil-fuel-divestment.html>

⁴ Over pre-industrial levels. See <https://www.climate.gov/news-features/understanding-climate/climate-change-global-temperature> for detail

⁵ <https://phys.org/news/2016-11-climate-extreme-weather-events-worse.html>. See

<https://www.carbonbrief.org/mapped-how-climate-change-affects-extreme-weather-around-the-world> for a full list of scientific studies showing human influence on extreme weather events

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¹⁵ Mark Carney, 29th September 2015. Breaking the Tragedy of the Horizon – climate change and financial stability

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¹⁷ The MacDonald reference in the text box is IIGCC, 2015. European investors welcome the unequivocal signal provided by the Paris Agreement - See more at: <http://www.iigcc.org/press/press-release/european-investors-welcome-the-very-strong-signal-provided-by-the-paris-agr>;

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²⁰ Impax Asset Management, 2016. Carbon risk for investors: Building a "Smart Carbon" portfolio.

http://www.impaxam.com/sites/default/files/Smart%20carbon%20WP%20final%20global%20_0.pdf

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