Environment Agency
Pension Fund

Strategy to reduce climate risk

The Environment Agency Pension Active Fund (the Fund) is a defined benefit Local Government Pension Scheme with over 23,000 members and assets of £2.1 billion. There is a 93 per cent participation rate of eligible members. The funding level at 31 March 2013 was 90 per cent.

The fund's fiduciary responsibility is to act in the best interest of its members. The Fund management recognises that financially material environmental issues can adversely impact on the Fund's financial risks and investment returns and thus should be taken into account in the investment strategy. Accordingly, the Fund has integrated the consideration of environmental, social and governance (ESG) issues throughout the funding and investment decision making process.

Climate change is a key financially material environmental risk for the fund, and as such we have developed a comprehensive and robust strategy to minimise the long term impacts on the fund value.

Action already undertaken

We became the first Local Government Pension Scheme signatory of the United Nations Principles of Responsible Investment (UNPRI) in July 2006. The principles reflect the view that ESG issues – including climate change – can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors in fulfilling their fiduciary duty.

We were a founder member (2001) of the Institutional investors Group on Climate Change (IIGCC) which is a "collaborative platform to encourage public policies, investment practices, and corporate behaviour that address long-term risks and opportunities associated with climate change". In 2004, we became a signatory to the CDP (formerly the Carbon Disclosure Project). As part of our support for this initiative we have engaged with our fund managers, highlighting companies within our portfolio, who are failing to disclose greenhouse gas emission levels or targets to the project, and urged them to do so. We also proactively support the CDPs programmes which focus on water disclosure by companies and those who use timberland or related commodities. We report progress on these engagements in our annual report accounts.

In 2010 we partnered with other asset owners globally, as part of the Mercer-led research, considering the implications of climate change scenarios on strategic asset allocation. We integrated the findings into our own review of our strategic asset allocation (SAA) to inform the development of a robust portfolio, where the investment strategy is positioned to reduce risk and maximise investment opportunities presented by climate change. In response to this in April 2013 we allocated £250 million investment in real assets covering real estate, infrastructure, forestry and agricultural land to Townsend group. The mandate places a high priority on long term responsible investments that meet our financial targets, with a preference to invest positively in real assets such as energy efficient buildings, renewable energy projects, public transport, water treatment facilities, eco-friendly farming, and sustainable forestry.

In response to the study above, the Environment Agency's Pensions Committee decided to adopt a more flexible approach to the Active Fund future investment strategy and asset allocation so that we can respond responsibly and robustly to both the changing global economic environment and the risk and impacts associated with climate change. As such, in reviewing the strategic asset allocation and investment strategy, climate change and other ESG risks are explicitly discussed by the Pensions committee and the Investment Sub-group. We used the Mercer SAA methodology in 2012 to understand the benefits of the SAA changes in relation to overall climate risk and will continue to explore ways to improve integration into the funding strategy and SAA.

We have embedded the consideration of ESG risks, including climate risk into every stage of the funding and investment cycle. Our efforts were recognised in the Asset Owners Disclosure Project Global Climate Index 2013-14 where we were ranked as the leading global pension fund for the management and disclosure of climate risk.

We aim to create an interactive area of the eapf.org.uk website that will address how we manage climate risk across the portfolio, including case studies for those who wish to see more detail. Some of the key actions taken to address climate risk are identified below.

Policy commitment

Climate risk is explicitly detailed in our policy documents

Allocation to clean and sustainable technology

As at 31 March 2013 13 per cent of the fund was invested in clean technology, if you add in broader sustainable themed investments the total rises to 23 per cent. Currently this only analyses public and private equity. With other investments in other asset classes we are confident we will hit our 2015 target of 25 per cent of the fund invested in the sustainable and green economy.

Annual assessment of carbon footprints

Each year we assess the relative carbon footprint of our active equities which is currently 26 per cent less carbon intensive than the MSCI ACWI and the overall footprint has reduced by 39 per cent since 2008. For active UK bonds the portfolio was 51 per cent more (carbon) efficient than the IBOXX benchmark, the bond market indices comprising liquid investment grade bond issues.

Disclosure and transparency

We detail our progress in the implementation of responsible investment in our annual report and accounts. In addition, we periodically publish a Responsible Investment Review of the active pension fund. Whilst this document sets out the practical implications for the fund on a broad range of environmental risks, the effects of climate change are a key issue that is addressed in the report.

Working collaboratively

We will continue to support the activities of the Institutional Investors Group on Climate Change, particularly through our participation in the policy and property working groups. This provides us with a collaborative platform to work alongside other investors and asset owners to encourage the adoption of strong and credible public policy solutions that ensure an orderly and efficient move to a low carbon economy, as well as measures for adaptation and informing investment practices to preserve and enhance long-term investment values.

We have also supported Share Action in development of their Green Light report which encourages pension funds and other institutional investors to take a proactive approach to managing climate risk.

Digging deeper

Climate risk and the issues associated with it are included in the training we provide to our pensions committee members; in 2013 this has included the research behind stranded assets. In late 2013, in response to new research we commissioned a detailed study on the exposure of the Active Fund to carbon embedded within fossil fuel reserves held by globally listed companies. This was both to highlight the potential risk of specific holdings (carbon stranded assets) that could be dealt with through our engagement with fund managers, and to look at the overall level of exposure of the fund to climate change risk of this nature.

A summary version of the report by Trucost is available on our website in the investments section. The recommendations in the report were:

Engage with legislators and reporting bodies for comprehensive fossil fuel reserves data to be disclosed in publicly available corporate reports. Ensure reserves are split out by each type of fossil fuel, accompanied by industry accredited emissions factors.

Engage management of fossil fuel extractives companies, asking them to explain their Capex programme regarding the development of new fossil fuel reserves and what plans they have in place to make a transformational shift to a lower carbon economy.

Divestment from the fossil industry is neither an industry-leading nor progressive strategy. Reducing investment exposure to the fossil industry does not precipitate a reduced prevalence of that industry. Be part of the conversation to influence the discussion.

Raise awareness of the stranded assets issue developing within the fossil industry; and one of the most effective tools in encouraging governments to legislate is gaining wider social acceptance of the business case for a transition to a low carbon economy.

Forward plan

The detail findings of the full report evidenced that the EAPF had made considerable progress in addressing climate risk, but that there were still opportunities to further reduce the financial risk to the portfolio and potentially increase the returns of the fund as a shareholder. We have identified 10 key areas of implementation to address our potential exposure to stranded assets and wider climate risk. We will publish progress against these actions via our website and in our annual report and accounts.

Transparency

Publishing a public report to highlight the key findings of the *carbon risk-stranded assets* research, both to inform members and to act as an advocacy piece on the potential financial risks associated with climate change.

Integration

Continue to embed climate risk as part of investment strategy and asset liability modelling and investigate investment opportunities to further reduce the level of climate risk assets in the portfolio. This includes wider portfolio risk from climate change e.g. extreme weather events on real estate or impact commodities.

Continue to provide training and on-going briefings on climate risk to ensure our Pensions Committee and Investment sub-group maintain their high level of awareness and understanding.

Measurement

Continue to measure, monitor and report the greenhouse gas footprint of our active equity and bond holdings in the Active Pension Fund and seek to expand the reporting to cover a wider range of asset classes.

Advocacy

Continue to raise awareness of the potential for a stranded assets issue developing within the fossil industry and actively support other pension funds in assessing climate risk in their portfolios.

Continue our work with the Institutional Investor Group on Climate Change, Carbon Disclosure Project (CDP) and other bodies to engage with legislators and reporting bodies to encourage the disclosure of comprehensive fossil fuel reserves data, publicly, preferably in their annual financial statements.

Working with our fund managers

Work with our fund managers to discuss specific holdings, if any, identified in the Carbon risk – Stranded assets report as being of particular high risk and on reporting and disclosure standards on fossil fuel assets. Ask them to ensure their analytics encompass the issues raised in stranded assets in term of evaluating company value and risk and ask our managers to engage with fossil fuel based companies to challenge the capital expenditure on the exploration of new fossil fuel reserves.

Update our voting policy to support resolutions seeking explanation of the company's capital expenditure on developing carbon assets and would normally support resolutions calling for capital to be either returned to shareholders or to investigate wider diversity of fuel sources rather than invested in new carbon assets.

To enable investors to properly asses individual companies' embedded emissions profiles and more fully illustrate those companies most exposed to carbon stores within their fossil reserves, we will ask our managers to engage with the fossil fuel companies in their portfolios to request disclosure for each type of fossil fuel reserve in the widely-recognised reporting format.

Ask each of our managers to identify and engage with companies in their portfolios with both direct exposure to fossil fuels or were fossil fuel is key to the supply chain, to support a transformational shift to a lower carbon economy.

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