Local Government Pension Scheme

Analysis of Net Zero targets

September 2024

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Executive summary

Climate change issues have been a preeminent topic within the global news and financial markets. The US saw a major heatwave earlier in the year, and emergency services in Europe and Canada have been dealing with a summer of wildfires, which have become increasingly frequent and intense in recent years. This increase in natural disasters brings to life the emergency we are facing right now, making it all the more important that countries and companies around the world deliver on their commitments to limit global warming in order to support targets under the Paris Agreement.

- **Pension schemes are not immune to this trend;** there has been an increase in regulation, notably the requirement for companies and institutions to report on how they manage climate change risks and opportunities under the TCFD framework, and more recently the new General Code for pension schemes has brought in a specific climate risk module.
- **Reporting against the Taskforce on Climate Related Financial Disclosures (TCFD)** has come into force for Local Government Pension Scheme (LGPS) from 1 April 2024, with first reports now required by late 2025*. However, pre-empting the reporting requirement, many LGPS funds have already taken steps to address climate change within their portfolios, including setting Net Zero targets.
- **This report summarises the key observations from our research** into LGPS TCFD reports and individual responsible investment / climate change policies, as well as our thoughts on how all LGPS funds can enhance / develop their approach towards climate change by sharing our experience of our work with private sector schemes.
- Within this thought leadership report we **investigate the LGPS funds' commitments to Net Zero** and what steps they have taken within their investment strategies to support the targets.
- Our research has included a **review of all 97 LGPS funds in England, Wales and Scotland,** and the **eight Asset Pools** (reviewing their TCFD reports where produced, or otherwise separate climate and responsible investment policies).

This is an area of development for all pension schemes, despite the progress seen to date. **We will continue to review and report on the status of LGPS funds over time,** with the intention to monitor the progress made; understand how they have responded to the TCFD reporting requirement; and any other changes to regulation or best practice.

LGPS funds have a responsibility to manage key investment risks associated with climate change, and are ideally positioned to take advantage of the long-term opportunities that will come with the climate transition.

Alex Quant
Head of ESG Research

*__Source:__ LGPS Advisory Board

Key findings

49%

of LGPS funds have a Net Zero target

- It is encouraging to see half of all LGPS funds have already set a Net Zero target or ambition. But conversely, this means half have not yet determined a Net Zero strategy or ambition.
- **Six out of the eight Asset Pools have a Net Zero target,** which will indirectly apply to those funds within the given Pool. The remaining two Pools have not yet indicated the intention to set a Net Zero target at the Asset Pool level.

2030

five LGPS funds are targeting Net Zero by 2030

- The majority of LGPS funds pursuing Net Zero are targeting 2050. But some funds have set themselves more challenging targets, including five that are pursuing Net Zero by 2030.
- **56% of the LGPS funds with a Net Zero target** have set an interim target, mostly entailing a 50% reduction by 2030.

74%

described switching investments into strategies with a sustainable objective

- A high proportion of LGPS funds have switched their investments into strategies with a sustainable objective. This is a key step in enabling delivery of the overall target, by investing in strategies which exclude the worst offending companies, and tilt towards those companies best placed to deliver the low carbon transition.
- **95% described engagement** as a key tool to deliver the overall objective. LGPS funds can benefit here from the work of the Local Authority Pension Fund Forum (LAPFF) which undertakes engagement on their behalf.

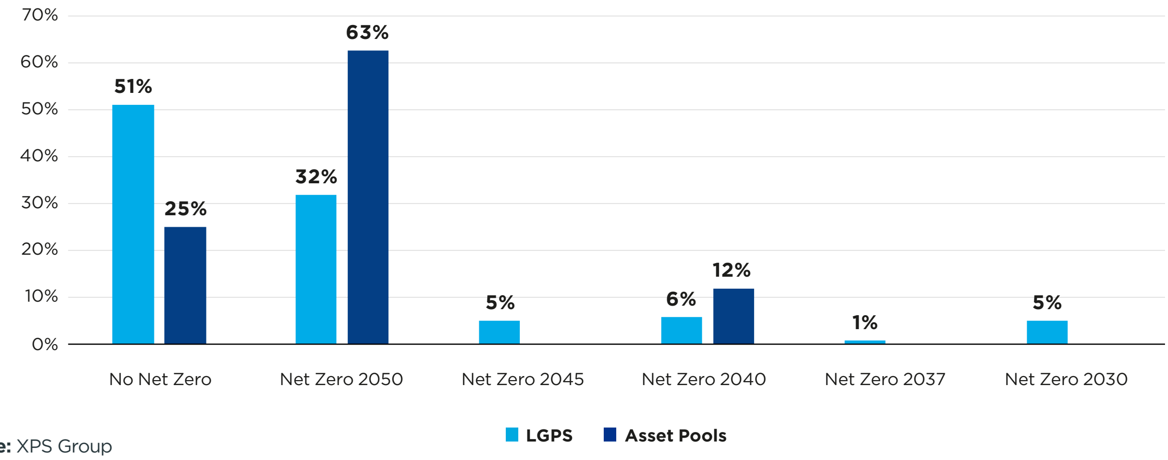
26%

of LGPS have directly invested in climate solutions

- With their scale, long-term horizon and appetite for illiquidity, LGPS funds have a clear opportunity to participate in impactful sustainable investments, such as renewable energy projects or forestry. There has been a growing trend toward impact-focused, or place-based investments (which focus on beneficial impact in a locality) where investors feel they can make demonstrable real-world difference with their investments.

1. Overview of approach to setting Net Zero targets

Net Zero targets set by LPGS funds and Asset Pools



Source: XPS Group

Approach taken by LGPS funds

49% of LGPS funds have set a Net Zero target. Global Net Zero requires reducing total greenhouse gas emissions to a level where the amount emitted is balanced by the amount removed from the atmosphere, in order to limit global warming and the resultant climate change. Countries and investors are increasingly setting their own Net Zero targets, to encourage flow of finance towards those companies who are contributing to the climate transition, and away from those companies whose operations are not compatible with a low carbon economy.

Of the 97 LGPS funds, 32% have disclosed that they have committed to reaching Net Zero by 2050, aligning themselves with the Paris Agreement. A further 17% have set more ambitious targets with earlier deadlines (the most ambitious being 2030 by five funds). This means the majority 51% did not disclose a Net Zero target.

By way of comparison, XPS also recently reviewed a sample of private DB pension scheme TCFD reports and found that 60% of schemes had set a Net Zero target. However, here there was a clear divide by scheme size, where 83% of £5bn+ schemes had set a target but only 35% of £1bn-£5bn schemes had set a Net Zero target. You can read the full report **here.**

Approach taken by Asset Pools

The LGPS statistics above cover where the fund explicitly sets the Net Zero target itself, as opposed to relying on the Net Zero strategy set by its overarching 'Asset Pool'.

In 2015 the UK government announced that it would work with LGPS administrating authorities to reform how the underlying funds were managed. The plan was for LGPS funds across England and Wales to pool their assets into a number of investment pools of at least £25bn each. The desired effect was for the pools to achieve economies of scale across all investment costs and therefore have increased capability to invest in infrastructure projects that can help to drive growth in the UK economy. Following the consultation, eight pension pools were formed, generally allocated by regions.

On the chart we have also illustrated the approach taken by the Asset Pools; we observe that six of the eight Pools have set a Net Zero target; five have set a Net Zero target of 2050, whilst one has set a more ambitious target of 2040. The other two Pools did not indicate a short-term intention to set a Net Zero target at the Pool level.

Interim targets

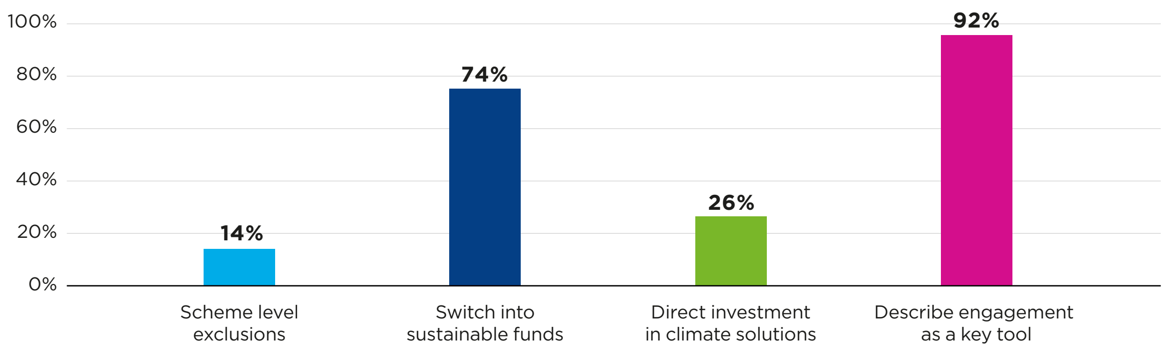
It's now well established that one of the key aspects of a robust Net Zero strategy is having an interim target; it is not viable to continue to emit at a high level up until 2050 without targeting a meaningful reduction in emissions over time.

56% of LGPS funds with Net Zero targets described interim targets, with the most popular (25% of funds) interim target being a reduction of 50% by 2030. 13% of funds with a Net Zero goal are looking to reduce emissions significantly by 2025.

2. Steps taken within investment strategies

Alongside looking at the overall targets which had been set, we also reviewed what steps had been taken by the funds to support their climate strategies. We summarised these across four broad approaches, and the chart below sets out the proportion of LGPS funds we saw adopting them. We captured this for all funds, including those who had not explicitly set Net Zero targets.

Action taken within investments to address climate risks



Source: XPS Group

It is clear the most popular lever funds described for delivering their climate objectives is **engagement**. Engagement is critical to understand risk and drive change in behaviour, particularly with those companies who are currently high emitters but who are important to facilitating the climate transition. LGPS funds are also able to leverage the work of the Local Authority Pension Fund Forum (LAPFF), as described below.

We observed a high proportion **(74%) switching their investments into funds with sustainable objectives** embedded alongside the financial objectives – for example, investment funds which have emissions reduction targets in line with recognised climate benchmarks, or targets to increase proportion of the portfolio invested in companies 'aligned' to Net Zero. The latter approach is critical to ensure a forward-looking viewpoint. Many Asset Pools indicated that they had switched their existing listed markets allocation into strategies which have underlying sustainable objectives such as decarbonisation or climate transition alignment targets.

14% of funds have set **scheme-level exclusion policies**, for example to fully divest from fossil fuels by 2030. Our view is that exclusions should be applied at a minimum level, and only for those companies who have not shown any intention to transition their operations / capital expenditure to align with a low carbon economy, and exclusions are most effective when they follow a period of engagement.

Positive steps have been taken by a number of underlying funds to directly invest in **climate solutions (26%)**, such as renewable energy projects. This is a great way to take an active role in meeting targets and contribute to meaningful change.

There is a growing consensus that a robust Net Zero strategy requires more than simply carbon reduction targets (where emissions metrics are inherently backward looking) and must involve investing on a forward-looking basis into those companies which are aligned to the transition to global Net Zero. Some funds did seem to recognise this, but it is important this is a key aspect of the implementation of Net Zero strategies going forward. The recent Net Zero Investor Framework 2.0 provides guidance on this issue, including the recommendation for investors to report on allocation to transition assets and climate solutions.

We noted many of the Asset Pools recognising this, and reporting on direct investments in renewable energy such as the emerging Hydrogen economy, and investment in forestry assets.

Leveraging the collective efforts of Asset Pools may be an efficient way for LGPS funds to make change and access solutions to enhance their approach. By pooling resources and expertise, funds could benefit from shared strategies, research and best practices.

A portfolio decarbonised through actions that do not reduce real economy emissions is likely to still be exposed to systemic financial risks.

Net Zero Investor Framework 2.0

3. Other considerations for LGPS when setting sustainable investment strategies

Impact Investing for LGPS going forward

As above we have seen **26% of LGPS funds indicated they have directly invested in climate solutions,** such as renewable energy projects, and many have goals to implement this into their strategies. LGPS funds, with their scale, long-term horizon and appetite for illiquidity, have a unique opportunity to participate in impactful sustainable investments. There has been a growing trend toward impact-focused, or place-based investments where investors feel they can make demonstrable real-world difference with their investments.

To support our clients, we have developed an **Impact Designation**, which is a hallmark we assign to funds that explicitly target and measure real world outcomes alongside financial returns. These impact investments can cover a number of themes including climate change, nature-based investments or social impact projects, where the investment case for the company directly aligns to the sustainable outcome it delivers.

A note on LAPFF and engagement

- Many of the LGPS fund reports we reviewed referenced the Local Authority Pension Fund Forum (LAPFF) as a key enabler of their climate / sustainable investment strategies.
- LAPFF is a voluntary association of public sector pension funds based in the UK. It represents 80 of the LGPS funds, combining £350bn of assets, to promote the investment interests of members and use their scale to promote high standards of corporate governance and responsibility among the companies in which they invest. They are concerned with topics such as executive pay, reliable accounting and largely a 'just' transition to a net zero economy. They engage directly with companies on behalf of local authority pension funds on such climate related matters, support collaborative initiatives such as Climate Action 100+ and advocate for strong regulatory frameworks that support the transition to a low carbon economy.
- This is a valuable resource that LGPS can leverage, but we would also encourage underlying funds to have close oversight of the engagement taking place on their behalf, and consider setting their own engagement priorities and strategy to support their broader objectives.

4. Summary and next steps for LGPS

It is critical that LGPS funds understand their exposure to climate risk, and as regulation comes into force for these funds, it provides a good opportunity to review and enhance the approach taken towards managing climate risk and target opportunities. For many this may involve developing a Net Zero strategy. By aligning investments with global Net Zero, LGPS funds can improve the resilience of their portfolios to climate shocks.

The Asset Pools may lead the way in terms of setting overall targets, and making available strategies which can be used by the underlying LGPS funds, but it is important that LGPS funds develop their own strategy in the context of their specific objectives and have clear oversight of how their investments deliver on those goals.

With scale and long-term horizon, we believe there is a real opportunity for LGPS funds to benefit from the climate opportunities created by the structural shift towards a low carbon economy, and there are investment strategies coming to market all the time which LGPS funds can participate in, as part of supporting their broader investment goals.

What can XPS do to help?

We have a clear framework for helping LGPS funds to enhance their approach and have lots of experience helping large pension schemes develop comprehensive climate change strategies, as well as report against the TCFD framework. We recommend the following steps:

1. **Clarify** your beliefs and priorities using our complimentary ESG Beliefs questionnaire here
2. **Review** the approach taken by your Asset Pool, where relevant, and whether that aligns to your preferences.
3. **Set objectives** on responsible investment priorities, which may include setting robust Net Zero targets.
4. **Assess** the current state of your portfolio, covering the overall approach towards ESG but more specifically how the current investments align to delivering global Net Zero.
5. **Make changes** where needed including considering switching into sustainable funds or pursuing impact investments which deliver demonstrable real-world benefits.
6. **Ongoing monitoring** and review against the objectives and targets set, using XPS ESG Ratings report and carbon dashboard, supported by XPS access to MSCI climate data and analysis.

Taking these steps will stand funds in good stead particularly as they prepare for TCFD reporting requirements.

It is important that LGPS funds continue to develop and enhance their approach to managing climate risk in the context of their specific objectives. This should include reviewing the approach taken by their respective Asset Pool to ensure it aligns to the fund's specific beliefs and priorities, so that opportunities are not missed.

Daniel Carpenter
LGPS Investment Lead

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Find out more

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