BABERGH DISTRICT COUNCIL

COMMITTEE: Cabinet	**REPORT NUMBER: BCa/21/37**
FROM: Councillor Simon Barrett Cabinet Member for Finance	**DATE OF MEETING: 10 January 2022**
OFFICER: Katherine Steel, Assistant Director, Corporate Resources Rebecca Hewitt, Acting Corporate Manager – Finance Operations	**KEY DECISION REF NO. CAB326**

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) CONSIDERATIONS FOR THE COUNCILS' TREASURY MANAGEMENT INVESTMENTS

1. PURPOSE OF REPORT

1.1 At its meeting on 17th May 2021, the Joint Audit and Standards Committee considered report JAC/20/21 which presented key considerations around developing an ESG policy for the Councils.

1.2 Following discussion of the report, the Committee resolved to make a specific request for Cabinet to consider. This report includes the recommendation that was made from Joint Audit and Standards Committee for Cabinet to discuss, but also includes an alternative recommendation that Cabinet wishes to consider along with relevant background information.

2. OPTIONS CONSIDERED

2.1 Consider the specific recommendation from Joint Audit and Standards Committee.

2.2 Consider an alternative recommendation that Cabinet wishes to adopt. This is the preferred option.

3. RECOMMENDATION

3.1 That Cabinet monitors the Council's treasury management investments in relation to all three aspects of ESG reporting as this develops and looks to make changes to investments at an appropriate time that would strengthen ESG performance but be within acceptable financial considerations.

REASON FOR DECISION

To ensure that the wider issues around environmental, social and governance are considered in relation to treasury management investments and not just the environmental issues raised by Joint Audit and Standards Committee

4. KEY INFORMATION

Introduction

4.1 The Council declared a climate emergency in 2019 and committed to investigate ways to achieve their ambition of making the organisation carbon neutral by 2030. Suffolk Public Sector Leaders have also committed to work together towards the aspiration of making the county of Suffolk carbon neutral by 2030.

4.2 Considering climate change-related risks in particular, increasing attention is being given to responsible investment by investors globally, resulting in an increasing appreciation that assessing ESG factors is not only a moral issue to be addressed, but also a key part of understanding long-term investment risk.

4.3 The Council's Joint Treasury Management Strategy for 2021/22 was approved for Babergh at its Council meeting on 18th February 2021, following recommendation for approval by the Joint Audit and Standards Committee on 25th January 2021. The Strategy does not currently contain any specific targets in relation to ESG.

4.4 The principles of Security, Liquidity and Yield, as set out in the CIPFA Treasury Management Code and Department for Levelling-Up, Housing and Communities (DLUHC) Investment Guidance, remain at the heart of local authority treasury decisions and risk management. Incorporation of any ESG principles need to be balanced against this.

ESG considerations

4.5 There is increasing awareness and inclusion of ESG issues within investment products for two key reasons.

- Long-term investment risk: as Government policies and customer/investor preferences change to address climate change, companies who do not or cannot adapt to meet these changes could become unsustainable.

- Ethical considerations: investors are increasingly interested in the impact that their investments are having on the world, rather than only being concerned with the financial returns.

4.6 As ESG is an emerging theme within local authority treasury management, the measurement and ability to truly compare the performance of investments from this perspective is still developing.

4.7 To underline this, in October 2021, subsequent to the discussion at Joint Audit and Standards Committee, the Government published a report, Greening Finance: A Roadmap to Sustainable Investing (publishing.service.gov.uk) with the aim of supporting the financial services sector to align with the UK's net zero commitment and wider environmental goals.

4.8 The roadmap sets out the Governments plans to implement new Sustainability Disclosure Requirements (SDR) to create an integrated framework against which comparisons and decisions can be made. This will include new requirements for asset managers and investment product disclosures.

4.9 The Government will be consulting on different aspects of the published roadmap over the coming months, with the first requirements likely to come into effect sometime during 2022. It will therefore be a further period before we can make consistent comparisons between investments, but this does not affect the recommendation from the Joint Audit and Standards Committee.

4.10 The discussion at Joint Audit and Standards Committee mainly centred around the Councils pooled fund investments, but also included money market funds. The pooled fund investments are held with different counterparties and cover a range of asset classes to reduce risk. The nature of these investments is that the Council is exposed to all the companies within the fund. If the Council wishes to divest from a particular sector within the fund, this can only be achieved by total divestment from that fund. The pooled funds in which the Council is currently invested are detailed below.

Fund	**Asset class**	**Investment Amount**
CCLA: LAMIT Property Fund	Property	£5,000,000
Ninety One (Investec): Diversified Income Fund	Multi Asset	£2,000,000
Schroders: Income Maximiser Fund	UK Equity	£2,000,000
UBS: Multi Asset Income Fund	Multi Asset	£2,000,000

4.11 At the time that Joint Audit and Standards Committee considered this issue, the United Nations Principles for Responsible Investment (UN PRI) was the main information that was available to make comparisons.

4.12 Each of the Council's fund management companies is a signatory to the UN PRI, they file comprehensive reports annually through the PRI reporting framework and are scored on their submissions, with the top score being A+. The scores for each fund and the median score for 2020 are as follows.

UN PRI Transparency Report: Assessment scores 2020	**Median score**	**CCLA**	**Ninety One**	**Schroders**	**UBS**
Strategy & Governance	**A**	**A+**	**A+**	**A+**	**A+**
<u>Direct and Active Ownership</u>					
Listed Equity – active ownership	**B**	**A+**	**A+**	**A+**	**A+**
Incorporation - screening		A+	A+	A+	A
Incorporation – integration		A+	A+	A+	A
Individual engagement		A+	A+	A+	A+
Collaborative engagement		A+	A+	A+	A+
Proxy voting		A+	A+	A+	A
Fixed Income – Sovereigns, Supranational and Agencies (SSA)	**B**	**--**	**A+**	**A**	**A**
Fixed Income – Corporate Financial	**B**	**--**	**A+**	**A**	**A**
Fixed Income – Corporate Non-Financial	**B**	**--**	**A+**	**A**	**A**
Fixed Income – Securitised	**B**	**--**	**--**	**A**	**A**
Private Equity	**A**	**--**	**A**	**A+**	**--**
Property	**B**	**A+**	**--**	**A**	**A+**
Infrastructure	**A**	**--**	**A+**	**--**	**A+**

4.13 Whilst the scores in the table above suggest good performance, none of these are badged specifically as ESG funds. They each take steps to analyse the ESG impact of their investments and engage with companies to address climate change risks.

4.14 It was acknowledged at the Joint Audit and Standards Committee that the UN PRI framework demonstrates how activity is disclosed and not necessarily what they are ultimately investing in and how these fit with the Council's ambitions.

4.15 The Committee had an in-depth discussion about the pros and cons of the current pooled fund investments and whether they were going far enough in relation to fossil fuels, with differing views being expressed about the best course of action. The advice of officers within the Environment Directorate is that if the Council wishes to achieve carbon neutrality it should not hold any investments in fossil fuel extraction businesses. These businesses, if they do not change and adapt, are unlikely to provide a sustainable income yield in the medium to long-term. Cabinet is asked to consider this advice and whether it wishes to support the approach.

4.16 The current performance and valuation of the existing funds was also discussed, again with differing views, as to whether the current funds should be liquidated at a loss to enable the investment in ESG targeted funds, which may give lower investment returns in the short to medium-term, but potentially stronger performance in the medium to long-term. Some committee members felt that this was an acceptable cost to the Council to take the necessary action as part of the carbon reduction priority, but others wished to give the funds time to recover to their investment value before changes were made.

4.17 There was consensus from the Committee that using the Council's investments to support the ambition to get to net zero carbon by 2030 was the right thing to do, but the approach to achieve this was expressed in different ways. Following further discussion, the Committee agreed on the wording in paragraph 4.20 below.

4.18 The two key methods under which action can be taken to seek better ESG performance are to either influence or exclude. The recommendation from Joint Audit and Standards Committee, first seeks to influence, but then to exclude, if insufficient reassurance is given by the fund managers.

4.19 The end of September valuations of the pooled funds, as presented to Joint Audit and Standards Committee on 29th November, in the half-year treasury management report for 2021/22, along with the current returns are set out in section 6 below.

4.20 The Committee's recommendation to Cabinet was:

That Cabinet pushes its fund managers to filter investments in respect of the ESG considerations, looking for positive contributions to tackling our carbon reduction priorities and that the Cabinet considers withdrawing funds from investors who do not adequately address these concerns. The Joint Audit and Standards Committee recognises that any decision to withdraw funds should be balanced against financial prudence.

4.21 It is believed that the discussion and recommendation from Joint Audit and Standards Committee was too narrowly focused on the environmental aspects of ESG, especially fossil fuels, and did not adequately address the wider determinants under the social and governance aspects. An alternative recommendation has therefore been put forward for Cabinet to consider.

4.22 This revised recommendation should be assessed against the following considerations in order to reach a conclusion:

- The reputational risk of not adopting an ESG approach in accordance with the timeline adopted by the Council in its climate change emergency declaration

- The financial risks as set out in section 6 of the report below

- The information available to reach an informed view across the three aspects of ESG

5. LINKS TO THE JOINT CORPORATE PLAN

5.1 This report links to the ambition to be carbon neutral by 2030 in the Joint Corporate Plan. Adoption of an ESG policy would not directly reduce emissions in our district but would assist in changing conditions more widely. The fund managers for the Council's strategic pooled funds are performing well with regards to the integration of ESG factors into their investment decisions and company engagement.

5.2 The income generated by the Council's pooled fund investments contributes to the resources available to the Council to meet the ambitions of the Joint Corporate Plan.

6. FINANCIAL IMPLICATIONS

6.1 The Council's strategic pooled funds are held as long-term investments. Although the total overall return for each of these funds since investment has been positive, they have incurred unrealised capital losses.

6.2 The position of each fund as at 30th September 2021, as reported to Joint Audit and Standards Committee on 29th November, is set out in the table below.

Babergh	**Purchase Price £m**	**Valuation at 30/9/2021 £m**	**Cost(-) / Surplus (+) if sold £m**	**Rate of Return for 2021/22 to date**
CCLA – LAMIT Property Fund	5.000	5.125	+0.125	3.67%
Ninety-One (Investec) Diversified Income Fund	2.000	1.939	-0.061	4.20%
Schroder Income Maximiser Fund	2.000	1.586	-0.414	6.14%
UBS Multi Asset Income Fund	2.000	1.834	-0.166	4.35%
Total	**11.000**	**10.484**	**-0.516**	**4.36%**

6.3 It can be seen from the table above that three of the four funds are currently valued below their purchase price. Cabinet may wish to consider whether this is because they are over-reliant on high carbon industries, which the market is reflecting in the unit price and hence may never recover to their full value, or if it is just the current position in the economic cycle, which will return over time. Covid-19 has undoubtedly affected valuations over the last 18 months and there has been a recent upward trend. This trend may or may not return them to their full valuation, but equally could fall from the current position if the market sees them as unsustainable.

6.4 The Council's treasury adviser Arlingclose provided information for the report to Joint Audit and Standards Committee, that there are equity funds with income strategies that screen out fossil fuel extractors, or whose focus is on renewable energy and/or decarbonisation. The income generated initially tends to be lower than what the Council receives from their existing funds, but over a period this is likely to outperform conventional funds due to their long-term sustainability.

6.5 The yield (i.e., income) for these funds currently ranges between 0.5% to 3.3%, with most in the lower to mid end of this range. The upper end of the range of 3.3% for the fossil screening funds is 1% lower than the average yield of the Council's existing funds. For the Council's £11m investment this would equate to a reduction in income of £110k per annum, but this could be a short-term reduction to achieve a long-term higher return.

6.6 The Council has previously acknowledged that achieving the net zero ambition comes at a cost, for example by investing in hydrotreated vegetable oil (HVO) for the vehicle fleet. Cabinet should therefore consider the Councils treasury management investments in a similar light and whether losses on realisation and returns in the short-term is an acceptable cost to respond to the climate emergency.

7. LEGAL IMPLICATIONS

7.1 There are no legal implications arising from this report.

8. RISK MANAGEMENT

8.1 This report is most closely linked to significant risks No. 13 – We may be unable to respond in a timely and effective way to financial demands, No 18 – The Councils will not be carbon neutral by 2030 and also Corporate Risk No. 5E05 – if the Finance Strategy is not in place with a balanced position over the medium term the Councils will not be able to deliver the core objectives and service delivery may be at risk of not being delivered. Key risks are set out in the following table:

Risk Description	Likelihood	Impact	Mitigation Measures
If an ESG approach is the primary aim for treasury management investments, then the Council could see a reduction in the level of revenue income in the short to medium-term.	2-Unlikely	2-Noticeable	Security, liquidity and then yield continue to be the prime considerations for investments under the CIPFA Treasury Management Code. Adopt an approach that incorporates ESG into investment decision making, but also has parameters that consider the financial impacts of those decisions.

			In the medium to long-term, investments focussed on ESG will be more sustainable and higher performing.
If the Council does not divest its treasury management investments from fossil fuel businesses in accordance with the timeline adopted by the climate change emergency, then it could suffer reputational damage and miss an opportunity to assert wider influence over climate change factors.	2-Unlikely	2-Noticeable	Adopt an approach that incorporates ESG into investment decision making, but also has parameters that consider the financial impacts of those decisions.
If the Council waits for the current investments to return to their original value, then they could in fact fall further, and opportunities could be lost to move to low carbon alternatives.	2-Unlikely	2-Noticeable	Consult the Council's treasury management adviser, Arlingclose, in relation to the investments and their short-term valuations. Consider the level of acceptable cost to move to low carbon alternatives.

9. CONSULTATIONS

9.1 None.

10. EQUALITY ANALYSIS

10.1 An equality analysis has not been completed because the report content does not have any impact on the protected characteristics.

11. ENVIRONMENTAL IMPLICATIONS

11.1 A key focus of this report is the consideration of the environmental impact of the Council's treasury management investments.

12. BACKGROUND DOCUMENTS

12.1 Report JAC/20/21 Environmental, Social and Governance (ESG) considerations for the Council's Joint Treasury Management Strategy.

12.2 Report JAC/21/10 Half Year Report on Treasury Management 2021/22