Engagement versus Divestment

Supporting the transition to a low carbon economy

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Summary

The purpose of this paper is to debate the relative effectiveness of engagement versus divestment, in supporting the global transition to a lower carbon economy.

This paper follows an in-depth research project conducted for a Local Government Pension Scheme (LGPS) client, on the **relative effectiveness of engagement versus divestment, in bringing about the transition to a low carbon economy**. It follows some stakeholder pressure on the pension scheme to divest from fossil fuels in their entirety. Whilst it focuses on portfolio-level impact, it also reflects on the wider market considerations that become relevant to investors beyond the portfolio.

We ultimately conclude that the industry evidence is mixed on whether engagement or divestment is more effective in bringing about decarbonisation action. However, it is clear from the interviews conducted with investment managers and wider industry research that engagement remains the preferred approach of investors. There is however some nuance that needs to be recognised here, namely that escalation processes may ultimately lead to the selective disinvestment of select names or groups as a result of a lack of traction from engagements. Therefore divestment and engagement are not necessarily polarised processes.

From the regulatory perspective, fiduciary duty means trustees will need to deliver the best return for a set level of risk. Trustee fiduciary duty adopts a primarily financial focus, albeit non-financial factors (within which, in our experience, legal advisors have included the climate emergency) can be considered under set circumstances. Ultimately, there is no clear-cut guidance on engagement versus divestment, beyond the climate requirements such as TCFD for larger pension schemes nodding to a preference for engagement and collaboration.

From the investment perspective, the impacts of divestment could be relatively significant, with evidence that there could be compromises in terms of risk, return, and diversification of investments. Where undertaken immediately, and where more illiquid investments are not allowed to run-off over longer-term timeframes, the costs could be particularly significant. There may also be additional costs resulting from transitions, or in the context of LGPS, penalties from exiting pooling arrangements, or a loss of efficiencies of scale, for example.

Ultimately, the approach that investors take will need to be grounded in their respective views on the best approach to tackling the climate emergency. This can be founded in investor belief sessions, developing bespoke approaches to implement this, in practice. We note this however becomes increasingly complicated in the context of LGPS schemes (on which this summary paper is based.)

Background

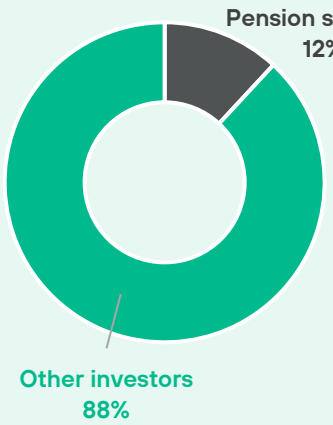
In 2015, global governments agreed the Paris Agreement, to achieve a well below 2°C scenario, with ambition towards 1.5°C. The latter 1.5°C target would translate into a ~2050 net zero commitment, provided sufficient interim decarbonisation to 2030, with many investors committing to this goal. In a recent investor survey, released this year, net zero commitments reached a quarter of investors surveyed (with broader decarbonisation efforts reaching half of those surveyed).[1]

As we head into Conference of the Parties (COP) 28 in the Middle East later this year, **we remain off track**. According to the United Nations Global Stocktake, we are heading towards a 2.5°C outcome this century, falling short of the Paris Agreement.[2] The United Nations are therefore calling on investors to support the scaling up of climate financing, including investments in low carbon opportunities (e.g. renewables and electric vehicles) and nature-based solutions (e.g. forests).[3]

The fossil fuel landscape is meanwhile becoming increasingly complex. There has been public scrutiny on fossil fuel companies, as oil and gas majors continue to set out ambitious climate aims, whilst continuing significant fossil fuel-related capex.[4] But this should not be the only focus, as private market companies are increasingly integrated in the fossil fuel sector,[5] whilst national oil companies (fully or majority government owned) account for over half of global oil and gas production, and an even greater proportion of fossil fuel reserves.[6] Meanwhile, rising inflationary forces, in light of the Russian war in Ukraine, Covid-19 pandemic and beyond are resulting in rising fossil fuel prices and returns,[7] supporting new fossil fuel exploration and production.

In the midst of the tension between climate action and inaction, investors have been looking to deploy approaches to tackling the climate emergency. Fossil fuel divestment commitments continue to grow, with a minority of this being commitments by pension schemes.[8] In the interviews conducted for this paper, and from a wider literature review therein, it is clear that for the majority of investors, engagement is the preferred approach.

Chart: Global divestment commitments, 2023



[1] Robecco. (2023) *Global Climate Survey. Investors remain committed to net zero.* Global Climate Survey – Investors remain committed to net zero (robeco.com)
[2] United Nations. (2023) *Why the global stocktake is a critical moment for climate action.* Why the Global Stocktake is a Critical Moment for Climate Action | UNFCCC
3 Including reference in: United Nations Environment Programme (UNEP). (2022) *State of Finance for Nature.* State of Finance for Nature 2022 | UNEP - UN Environment Programme. And: United Nations (UN). *Financing Climate Action.* Climate Finance | United Nations
4 Wilson, C., Limburg, A., & Caldecott, B. (2022). *Implications of the International Energy Agency Net Zero Emissions by 2050 Scenario for Net Zero Committed Financial Institutions.* Implications-of-the-International-Energy-Agency-Net-Zero.pdf (ox.ac.uk)
[5] Environmental Defence Fund (EDF). *Transferred Emissions: How risks in oil and gas M&A could hamper the energy transition.* Transferred-Emissions-How-Oil-Gas-MA-Hamper-Energy-Transition.pdf (edf.org)
[6] IEA. (2020). *The oil and gas industry in energy transitions.* The Oil and Gas Industry in Energy Transitions – Analysis - IEA And: IEA. (2022) *Share of government/SOE ownership in global energy investment by sector, 2015 compared to 2019.* Share of government/SOE ownership in global energy investment by sector, 2015 compared to 2019 – Charts – Data & Statistics - IEA. And: Armour, J., Enriques, L. and Wetzer, T. (2022) *Dark and Dirty Assets: Greening Climate-Driven Asset Partitioning.* Dark and Dirty Assets: Greening Climate-Driven Asset Partitioning | Oxford Law Blogs
[7] International Energy Agency (IEA). (2021) *What is behind soaring energy prices and what happens next?* What is behind soaring energy prices and what happens next? – Analysis - IEA
And: Bloomberg. (2023) *Israel-Hamas war threatens energy prices, adding to inflation risk.* Israel-Hamas War Threatens Energy Prices, Adding to Inflation Risks - Bloomberg
[8] Divestment Database. Homepage - Global Fossil Fuel Commitments Database. Homepage - Global Fossil Fuel Commitments Database (divestmentdatabase.org)

This paper

In this paper, we aim to present a balanced view on the relative effectiveness of engagement versus divestment, in bringing about the transition to a low carbon economy. This paper is a summary drawn from a client research project, comprising multiple papers. We note that definitions are important and these can be found in the Appendix.

This paper is composed of following sections:

- The industry evidence on the topic of engagement versus divestment in climate action.
- The legal view on engagement versus divestment, focusing on the context of trustee fiduciary duty.
- The investment implications, including an LGPS case study on the impact of divestment on investment risk and return.

The special case of LGPS

Throughout this paper, we refer to the specific circumstances in which LGPS schemes operate. In working within a pooling context, the individual setting of climate beliefs and climate strategy may be increasingly confounded by complicated governance arrangements. We address this specifically within this paper.

We note the direction of travel of LGPS pools differs across the UK landscape. We are seeing an increasing trend of LGPS who offer a range of sustainable, low carbon or fossil fuel exclusion investment options. For example, Brunel supports disinvestment from specific fossil fuels and other carbon-intensive companies, if they present a material investment risk (e.g. risk of stranding) based on analysis by the investment managers, as opposed to applying a blanket divestment on all fossil fuels.[9] Meanwhile, Border to Coast have committed to engaging with all oil and gas companies they are exposed to on their decarbonisation strategies – and encourage the use of voting and engagement ("using the strength of their collective voice") to drive progress.[10] We also note there are a number of LGPS pension funds, party to different LGPS pools in England and Wales, who are currently exploring, the relative merits of fossil fuel divestment versus engagement. The absence of a material number of divestment pledges to date may be in part the result of the practical challenges of individual funds pursuing fossil fuel divestment outside of their LGPS Pools. It is however likely that fossil fuel divestment pressures will continue for LGPS funds for the foreseeable future.

[9] Brunel Pension Partnership (2023) *Our approach to engagement and divestment:* Our approach to engagement and divestment - Brunel Pension Partnership
[10] Border to Coast (2023) *Border to Coast Calls for Greater Climate Action from Oil Majors and Banks* BORDER TO COAST CALLS FOR GREATER CLIMATE ACTION FROM OIL MAJORS AND BANKS - Border To Coast

Industry Literature

Renewed focus is required in light of evidence that suggests neither engagement nor divestment has been entirely effective to date in supporting the transition to a low carbon world.

Ultimately, neither engagement nor divestment have been entirely effective to date in delivering a low carbon transition.[11] Renewed action is therefore needed to tackle the climate emergency.

Divestment

The divestment movement has been growing as a result of climate action pressures. With divestment having had some success in reducing financing to fossil fuel companies,[12] this may have resulted in some unintended consequences. For example, domestic divestment pressures can simply result in the re-allocation of fossil fuel financing overseas,[13] requiring a global approach to be taken.

Some argue divestment may perversely result in higher fossil fuel prices – as supply is restricted without directly impacting on fossil fuel demand. In this case, the result can be stronger returns for investors, encouraging more capital into the sector.[14] We have seen this come to light, with the shock to fossil fuel prices arising from the Russian war in Ukraine. Demand-side reduction therefore needs to be front and centre of any climate change response, beyond actions to tackle production. (At the other end of the argument, contrary evidence suggests divestment may be impactful in influencing market norms, which indirectly cause downward pressure on fossil fuel prices as a result of stigmatisation.[15])

Ultimately, exiting an investment from a company offender serves to end the dialogue with that company, and may not bring about the desired societal change (tackling the climate emergency), as compared with engagement.[16] A major concern in the literature is that divestment could leave capital in the hands of less climate conscious investors,[17] potentially slowing down the transition to a low carbon economy.

Beyond a blanket divestment approach (where the owner of assets commits to a blanket removal of a specific investment class from the investable universe), investors can also consider a more nuanced exclusion approach on selective fossil fuels or high carbon projects, depending on when these projects are expected to become uneconomic (or stranded). This is referred to as **selective disinvestment**. For example, investors adopting exclusions on thermal coal, whilst continuing to engage with oil and gas producers on decarbonisation (given peak coal production should have occurred in 2020 to align with a 2050 net zero outcome, and peak oil and gas is expected to occur in the future).[18]

[11] Various sources, including: Quigley, E., Bugden, E. and Odgers, A. (2021) *Divestment: Advantages and Disadvantages for the University of Cambridge*. sm6_divestment_report.pdf (cam.ac.uk)
And: Broccardo, E., Hart, O., and Zingales, L. (2020) *Exit vs. Voice*. exit_vs_voice_1230 (harvard.edu)
[12] This focuses on bond and loan financing, or the majority of fossil fuel financing. Source: Cojoianu, T. Ascui, F. Clark G, Hoepner, A. and Wojcik, D. (2021) *Does the fossil fuel divestment movement impact new oil and gas fundraising?* Does the fossil fuel divestment movement impact new oil and gas fundraising? | Journal of Economic Geography | Oxford Academic (oup.com)
[13] Caldecott, B., Ansar, A. and Tilbury, J. (2013) *Stranded assets and the fossil fuel divestment campaign: what does divestment mean for the valuation of fossil fuel assets?* SAP-divestment-report-final.pdf (ox.ac.uk)
[14] Carlyle. (2022) *Global Insights: Energy Transition*. Carlyle_Global_Insights_Energy_Transition_Jason_Thomas_May_25_2022.pdf
[15] Caldecott, B., Ansar, A. and Tilbury, J. (2013) *Stranded assets and the fossil fuel divestment campaign: what does divestment mean for the valuation of fossil fuel assets?* SAP-divestment-report-final.pdf (ox.ac.uk)
[16] Broccardo, E., Hart, O. and Zingales, L. (2020) *Exit vs Voice*. exit_vs_voice_1230 (harvard.edu)
[17] James, C. (2022) *Don't Sell Your Fossil-Fuel Stock If You Want to Make a Climate-Change Difference in 2022*. Don't Sell Your Fossil-Fuel Stock If You Want to Make a Climate-Change Difference in 2022 | TIME
[18] International Energy Agency (IEA) (2021) *Net Zero by 2050*. Net Zero by 2050 – Analysis - IEA

Engagement

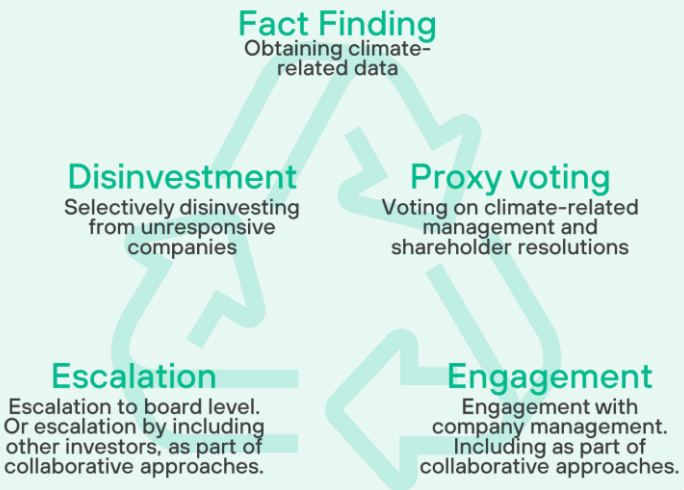
Engagement (a purposeful, targeted communication with an entity with the goal of encouraging change at an individual issuer or market-wide level)[19] can be explored via a range of approaches and methods. At a high-level, it remains difficult to attribute a company's climate action improvements to specific engagement activity with that company.[20] Looking to wider market developments, broad passive investments are also on the rise,[21] with investors potentially less exposed to active ownership approaches (albeit this is not necessarily the case, as the largest UK passive managers in the UK market have significant engagement programmes).[22] This creates a complicated landscape for investor engagement.

Concerns meanwhile remain on the effectiveness of engagements. There are concerns a significant amount of oil and gas majors' shareholder capital is being deployed to climate branding and lobbying.[23] With the recent flip-flopping of some oil and gas majors, such as Shell and BP, case and point in leaving investors questioning companies' climate commitments. With the mismatch between discourse and action resulting in accusations of greenwashing,[24] assessing the credibility of fossil fuel companies' climate claims may be essential.

The question becomes how to ensure engagements are effective? The chart below demonstrates a best practice approach to engagement, while the literature emphasises some key areas for attention:

Collective engagement is key to exerting stronger influence, representing more ownership, and enabling the pooling of knowledge and the costs of engagement.[25] If the full weight of pensions and other investors' influence were brought to bear on the issue, this could help to shift norms more quickly.

Chart: A circular and escalatory approach to engagement



The **escalation** of stewardship activities has been flagged as another facet to improving traction. In moving from voting activities to engagement meetings with management (with the setting of measurable KPIs), this could also include escalation to the threat of disinvestment.[26] Some argue this is necessary to ensure some companies are receptive to engagement. (However, others argue the knowledge that vocal shareholders may eventually disinvest could disincentivise them from acting on shareholder concerns, believing they can wait these shareholders out.[27]) This also blurs the line between engagement and disinvestment activities.

Ultimately, where companies' decarbonisation position changes over time, this warrants a **circular approach** to recognise the dynamic nature of the transition.

[19] ICSWG. (2021) *ICSWG Engagement Reporting Guide Version 2: introductory guidance.* Firm-level questions. b25a61_2f1090f92f30484590358785cd7a3a34.xlsx (live.com)
[20] Cited by various investment managers, with which Isio continue to engage with on an annual basis, on behalf of our clients.
[21] Bloomberg. (2021) *Passive likely overtakes passive by 2026, earlier if bear market.* Passive likely overtakes active by 2026, earlier if bear market | Insights | Bloomberg Professional Services
[22] "a passive investment style is not a barrier to having a leading approach to responsible investment". See report: ShareAction. (2022) *Point of No Returns 2023.* Point-of-No-Returns-2023-General-Findings_2023-03-01-115320_htgw.pdf (assets-servd.host)
[23] Influence Map. (2019) *Big Oil's Real Agenda on Climate Change* . InfluenceMap Big Oil's Real Agenda on Climate Change
[24] Li, M., Trencher, G. and Ausaka, J. (2022) *The clean energy claims of BP, Chevron, ExxonMobil and Shell: A mismatch between discourse, actions and investments.* The clean energy claims of BP, Chevron, ExxonMobil and Shell: A mismatch between discourse, actions and investments | PLOS ONE
[25] For example: The Investor Forum. (2019) *Collective Engagement: An essential stewardship capability.* The-case-for-collective-engagement-211119.pdf (investorforum.org.uk)
And: PRI. (2013) *Getting Started with Collaborative Engagement: How Institutional Investors Can Effectively Collaborate in Dialogue with Companies.* download (unpri.org)
[26] Adapted from: Lazard Asset Management. *Active Ownership.* Active Ownership | Lazard Asset Management
[27] Principles for Responsible Investment (PRI). (2022) *Discussing divestment: Developing an approach when pursuing sustainability outcomes in listed equity.* download (unpri.org)

Next, we focus on some of the key concerns for client portfolios.

Areas for Attention

Asset classes. Approximately ninety percent of fossil fuel external financing comes from debt,[28] and therefore a focus beyond listed equity holdings and proxy fights becomes essential. Fossil fuel investment is also increasingly flowing from listed into private markets, which carries the risk of fewer environmental commitments,[29] lower emissions transparency,[30] and lower receptiveness to stewardship activities. Tackling new and additional financing in primary markets would include a focus on venture capital, private equity, and later IPOs to tackle high carbon expansion.[31]

Range of stakeholders. There has been an understandable focus on oil and gas majors in tackling the climate emergency, particularly in relation to their high carbon capital expenditures.[32] There is however also a need to focus on other stakeholders, significantly implicated in fossil fuel value chains. For example, fully or majority owned public oil companies accounting for well over half of global production and an even greater proportion of reserves.[33] Or banks, whose loan origination provides circa two-thirds of new capital for fossil fuels, and whose underwriting serves new fossil fuel-related bond issues and IPOs.[34]

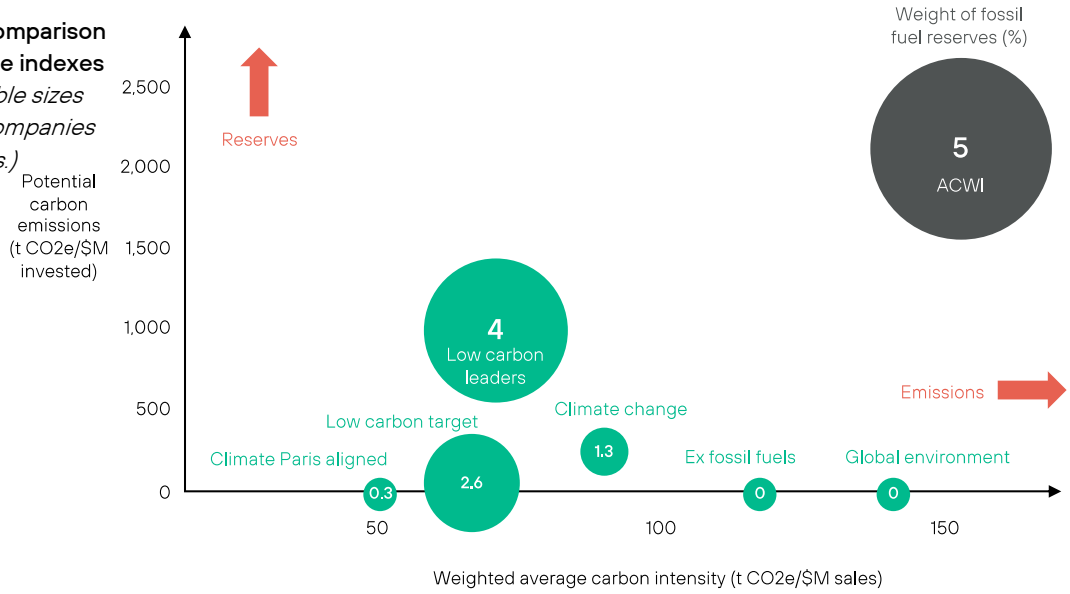
Beyond this, the literature also points to a focus on:

- UK climate **regulatory guidance** for pensions schemes, which we address later on, with the UK climate-related requirements for pension schemes placing a relative emphasis on engagement versus divestment. It may however be worth noting that other jurisdictions differ. For example, the French government could be gearing up to recommend fossil fuel exclusions on sustainable (Article 9) funds.[35]

- Understanding the **climate-related outcomes** for the portfolio. Ultimately, what is the investor trying to achieve? Firstly, decarbonisation analysis on equity indexes shows that a "low carbon target approach" (tilting away from companies with high emissions and fossil fuel reserves) achieved higher emissions reduction as compared with an "ex-fossil fuels" (divestment) index approach.[36]

[28] Quigley, E and Davies, S. (2021) *Stock picking for humanity.* Here are responsible shareholder tactics that actually work | Aeon Essays
[29] Environmental Defense Fund (EDF). *Transferred Emissions: How risks in oil and gas M&A could hamper the energy transition.* Transferred-Emissions-How-Oil-Gas-MA-Hamper-Energy-Transition.pdf (edf.org)
[30] There is debate as to the extent of transparency amongst privately owned energy companies. For example, see: MSCI. (2021) *2022 ESG Trends to Watch: Private-Company Emissions Under Public Scrutiny.* Private-Company Emissions Under Public Scrutiny - MSCI
[31] Quigley, E and Davies, S. (2021) *Stock picking for humanity.* Here are responsible shareholder tactics that actually work | Aeon Essays
[32] IEA. (2020). *The oil and gas industry in energy transitions.* The Oil and Gas Industry in Energy Transitions – Analysis - IEA
[33] IEA. (2020). *The oil and gas industry in energy transitions.* The Oil and Gas Industry in Energy Transitions – Analysis - IEA
[34] Quigley, E. and Davies, S. (2021) *Stock-picking for humanity.* Here are responsible shareholder tactics that actually work | Aeon Essays
[35] According to the EU SFDR rules. See: AMF. (2023) SFDR: The AMF proposes a targeted review to include environmental criteria. The Sustainable Finance Disclosure Regulation: the AMF proposes a targeted review to include minimum environmental criteria | AMF (amf-france.org)
[36] MSCI measures exposure to fossil fuel reserves via the potential emissions that would result if they were burned, for every $1 million invested, including only scope 1 & 2 (those direct emissions of a company, or which arise from the purchase of energy and heat). Sources: MSCI. (2015) *Beyond Divestment: Using Low Carbon Indexes.* Beyond Divestment: Using Low Carbon Indexes (msci.com) And: MSCI. (2021) *Understanding MSCI Climate Indexes.* Understanding MSCI Climate Indexes

Chart: carbon footprint comparison across MSCI ACWI climate indexes
(Source: MSCI. Note: bubble sizes represent the weight of companies holding fossil fuel reserves.)



Secondly, given emissions can be inherently backward-looking, forward-looking analysis may be important. For example, the Transition Pathway Initiative (TPI) has stated BP and Shell are aligned with a 1.5°C scenario with the highest rating of climate management quality.37 (We however acknowledge the recent signs of backtracking by these majors, which may shed light on the lags in bringing this data up to date.)

- **Stranded assets** are another significant risk for financial markets as the "switch away from fossil fuels to renewables, if not actioned in an orderly and planned way, risks stranding at least $100 trillion of assets across financial markets".[38] The discounting of future cashflow projections into present value terms significantly underrepresent risk in asset valuations, leading to a lower responsiveness across the investor industry. (Albeit, fossil fuel stranding could potentially be delayed by carbon capture, usage, and storage (CCUS), as well as offsetting (nature) solutions). A potential first step could be to understand those fossil fuels expected to experience the greatest low carbon transition risk. For example, as previously noted, thermal coal exposure was expected to enter decline in 2020 (assuming a 2050 net zero outcome).[39]
- There are also **broader social and environmental implications**. Decarbonisation decisions are inherently complex and need broader consideration. For example, where investors have increased exposure to renewables, with renewable infrastructure reliant on the metals and mining industry, this can be associated with significant value chain emissions,[40] human rights violations,[41] and associated job losses from the decline of the high carbon industry,[42] albeit some potential health-related gains from cleaner air.[43]

[37] In conducting a complete "strategic assessment" of climate change A "strategic assessment" represents the presence of a climate strategy, quantitative decarbonisation targets, plans to integrate climate-related risks and opportunities, an internal shadow price applied to carbon to inform the economic forecasting of projects, and senior remuneration linked to climate-related performance. TPI. *Transition Pathway Initiative Tool.* Tool – Transition Pathway Initiative
[38] Carbon Tracker Initiative. (2023) *ExxonMobil, Shell and systemic risk – prisoners of their assets?* ExxonMobil, Shell and systemic risk – prisoners of their assets? - Carbon Tracker Initiative
[39] Wilson, C., Limburg, A., & Caldecott, B. (2022). *Implications of the International Energy Agency Net Zero Emissions by 2050 Scenario for Net Zero Committed Financial Institutions.* Implications-of-the-International-Energy-Agency-Net-Zero.pdf (ox.ac.uk)
[40] McKinsey. (2022) *The raw materials challenge: How the metals and mining sector will be at the core of enabling the energy transition.* The raw-materials challenge: How the metals and mining sector will be at the core of enabling the energy transition | McKinsey
[41] Business and Human Rights Resource Centre. *Transition Minerals Tracker.* Transition Minerals Tracker - Business & Human Rights Resource Centre (business-humanrights.org)
[42] World Economic Forum (WEF). (2022) *What's the price of a green economy?* Transitioning to a green economy will cost the world another $3.5 trillion a year | World Economic Forum (weforum.org)
[43] IISD. (2019) *Tackling Coal-Driven Air Pollution in China and India: Lessons learned for Indonesia.* Tackling Coal-Driven Air Pollution in China and India: Lessons learned for Indonesia (iisd.org).

Regulatory Guidance[44]

Whilst we provide some high-level takeaways on regulatory developments, investors should seek out independent legal advice when considering divestment matters.

This section is a brief summary of research conducted by a legal advisor.

Fiduciary Duties

The following three principles will encapsulate trustees' fiduciary duty and the need to act in members' best (financial) interests, including:[45] the powers to invest are made for investment purposes only (and not e.g. political views);[46] they generate returns to pay members (and their contingent beneficiaries) when due;[47] and, such investment decisions are taken prudently,[48] with a reasonable level of skill and care, on the basis of proper advice.[49]

Ultimately, this is interpreted as securing the **best realistic return over the long-term whilst controlling for risks**.[50] The approach to risk emphasises modern portfolio theory, and diversification, or focusing on the risk of the portfolio as whole, as opposed to each investment individually.[51] (We however note that modern portfolio theory focuses on the diversification of financial factors, without strong consideration of systemic sustainability risks which may be less diversifiable, from climate change to the Covid-19 pandemic.) From the climate perspective, risks may vary in the long-term and should be considered over the holding period (e.g. an investment in an energy company transitioning from high to low carbon energy sources may not pose a significant risk in the future). Finally, where factors determining investment decisions should be financial in nature;[52] non-financial factors (e.g. climate change) can be considered if pension members are believed to share the concern[53] and there is no risk of significant financial detriment.[54]

Other Relevant Legal Duties

Beyond the fiduciary duty, there are a number of other relevant legal duties to consider. For example, the need to set out the policy on how environmental, social and governance considerations are taken into account by pension schemes, or the policy on the exercise of rights attaching to investments (e.g. voting rights). When

[44] This section is based on advice from Eversheds Sutherland.
[45] Law Commission. (2014) Paragraph 6.15 of the Law Commission Report. Fiduciary Duties of Investment Intermediaries - Law Commission.
[46] Law Commission (2014). Paragraph 6.12(1) of the Law Commission's *Report on the Fiduciary Duties of Investment Intermediaries*. Fiduciary Duties of Investment Intermediaries - Law Commission.
[47] Law Commission (2014). Paragraph 6.6 of the Law Commission's Report on the Fiduciary Duties of Investment Intermediaries (2014). Fiduciary Duties of Investment Intermediaries - Law Commission.
[48] English Case Law: Re Whiteley (1886) 33 Ch D 347.
[49] Martin v City of Edinburgh District Council. (1989) Pens LR 9 and Regulations 7(1) and 9(4) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.
For the regulations, see: The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (legislation.gov.uk)
[50] Law Commission (2014). Paragraph 5.56 of the Law Commission Report. Fiduciary Duties of Investment Intermediaries - Law Commission.
[51] Nestle v National Westminster Bank plc (1996) 10(4) Trust Law International 112 at 115, by Hoffmann J.
[52] Law Commission (2014). Paragraph 6.24 of the Law Commission Report. Fiduciary Duties of Investment Intermediaries - Law Commission.
[53] Law Commission (2014). Paragraph 6.34(1) of the Law Commission Report. Fiduciary Duties of Investment Intermediaries - Law Commission.
[54] Harries v Church Commissioners [1992] 1 WLR 1241 and paragraph 6.34(2) of the Law Commission Report referred to in footnotes above. We note that, in R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Communities and Local Government [2020] UKSC 16, the Supreme Court referred to the test as requiring no "significant risk of financial detriment" (rather than no risk of significant financial detriment). The difference is not just semantics and can have practical consequences, but we believe it was inadvertent.

looking to the climate requirements for pension schemes, the **UK government currently advocates engagement and collaboration** with business, as opposed to divestment.[55] This is however voluntary guidance and not a requirement on pension scheme approaches to decarbonisation.

Ultimately, the **Secretary of State has the power to intervene** in the investment function of an administering authority if satisfied that it is failing to act in accordance with regulations. This authority has however yet to be used, in practice.

Additional Considerations for LGPS

In the context of LGPS, there will be further regulatory duties,[56] including in setting out the approach to pooling investments. Whilst all trustees bring with them their own knowledge and experience, **political views must form no part** of the consideration of issues or of the decision-making process – and it is required that the Trustee Board has a political balance in their membership.[57] In the context of fiduciary duty, one legal opinion recognised that authorities are under no legal obligation to consider investment decisions from any other perspective than the maximisation of returns, following a social housing investment example, which stood up as savvy investment in its own right.[58]

[55] UK Government. (2021) *The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021.* Taking action on climate risk: improving governance and reporting by occupational pension schemes - GOV.UK (www.gov.uk)
[56] This includes the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (legislation.gov.uk)
[57] UK Government (1989) *Local Government and Housing Act.* Local Government and Housing Act 1989 (legislation.gov.uk)
[58] In 2014, the Local Government Association on behalf of the LGPS Shadow Scheme Advisory Board obtained legal advice from Nigel Giffin King's Counsel.

Investment Implications

Whilst supporting climate action, the financial implications of any agreed divestment policies should be considered.

Fossil fuel exposure

According to recent research, the UK pensions industry has invested over £88 billion in the fossil fuel industry, equivalent to ~£3,100 for each UK pension scheme member.[59] BP and Shell were amongst the top holdings of pension schemes, showing the predominance of oil and gas majors in pension investments.[60] Beyond pensions, investments in the energy system show a duality in low and high carbon investment. Last year, over $1 trillion was invested in clean power, the same amount that was invested in oil and gas production.[61]

Financial implications of divestment

The impact on risk and return from divestment could be potentially significant. In this section, we present high-level takeaways from the analysis conducted for an LGPS client of Isio's. The financial implications of divestment will necessarily be client-specific, therefore individual analysis would be required to understand the impacts for your pension scheme, in particular.

Table: Isio strategic modelling of fossil fuel divestment, for an example LGPS pension scheme
Note: based on an example LGPS scheme looking to divest from the following mandates with fossil fuel exposure: 2 diversified growth mandates; 2 private equity fund-of-fund mandates; and, 2 infrastructure mandates.

Metric	Current target strategy	Impact of divesting from fossil fuels in public and private markets
Expected return (%)	7.8%	-0.4%
Value at Risk (% difference change)	Baseline	+12%

Overall, we found that the impact would be much more significant if the pension scheme pursued both immediate fossil fuel divestment, and a divestment which included private market mandates in the portfolio. We note some subjectivity in calculating accurate cost estimates and so some of the costs may be underestimated, and the impacts would be different under the various potential climate pathways.

- **Public markets** – the diversified growth mandates would need to be replaced by ex-fossil fuel alternatives, with a marginal ~0.1% expected loss in value for the mandates.[62]
- **Private markets** – the transaction costs of immediate divestment from private market assets would be significant, as a result of significant haircuts (on infrastructure and private equity mandates), equivalent to 1.4% of portfolio value.[63]

[59] Make My Money Matter. 2023) *Fossil Fuels in UK Pensions report.* Fossil Fuels in UK Pensions report (makemymoneymatter.co.uk)
[60] Make My Money Matter. 2023) *Fossil Fuels in UK Pensions report.* Fossil Fuels in UK Pensions report (makemymoneymatter.co.uk)
[61] Baker, R. (2023) $1 Trillion Green Investment Matches Fossil Fuels for First Time. Bloomberg, $1 Trillion Green Investment Matches Fossil Fuels for First Time - Bloomberg
[62] Data provided by the investment managers..
[63] Isio calculations. Based on data provided by the investment managers.

Additional costs to consider may include:[64]

- Additional costs associated with loss of diversification. These are a result of the narrowing of investment options for pension schemes, given that divestment could minimise the potential strategic asset allocation that the scheme may consider (e.g. by limiting exposure to infrastructure assets with fossil fuel exposure).

- Another key risk analysed was re-pricing risk impacting on pension scheme performance, with stranded asset risk considered to be an extreme case of this (where assets become uneconomic). As previously noted, the widespread discounting of impacts on future cashflow projections will significantly underestimate stranding asset risk, in current valuations.

Practical considerations for LGPS

When considering LGPS schemes, **additional financial and governance considerations become important**. For example, the threat of intervention from the Secretary of State for pursuing ex-fossil fuel options, off pool, where available pooled funds fail to offer this optionality. (Albeit these government powers have yet to be tested). The current government consultation in relation to LGPS investments, "Next steps on investments", is re-emphasising asset pooling acceleration and expansion.[65] Considering this is the direction of travel, there may be increased pressure on LGPS pools to add new sustainable offerings to the pool in the future. This development of new investment options can take significant time, and some LGPS have focused on adopting a fund-of-fund approach, to bring multiple sustainability funds online at the same time. But given many LGPS pools do not employ a formal fossil fuel policy, there will not be a standardised approach, nor freely available fossil fuel-free investment options, resulting in LGPS funds looking to divest outside of the pool. Such exit from the pool would incur implementation costs, a potential exit penalty, and reputational risk, as well as loss of efficiencies of scale from pooling, beyond possible intervention.

[64] For example, we have been unable to quantify any increased fees for direct investment (outside the Pool) vs the economies of scale of the Pool, additional custodian fees as a result of ex-fossil fuel segregated mandates, additional fees for leaving the Pool, and any additional fees from increased level of resulting due diligence, manager selection exercises, and performance monitoring. We Further note some managers (M&G, Adam Street and Harbourvest) were unable to provide information of alternative ex-fossil fuel offerings in order to incorporate into this analysis. As a result the estimated return and cost implications may be underestimated.

[65] UK Government. (2023) *Local Government Pension Scheme (England and Wales): Next steps on investments* Local Government Pension Scheme (England and Wales): Next steps on investments - GOV.UK (www.gov.uk)

Conclusions

This paper was written to debate the relative effectiveness of engagement versus divestment, in supporting the global transition to a lower carbon economy.

We have explored the industry evidence, as dictated in the literature, which ultimately does not conclude which course of action is most effective, but that the preference of the industry is one of engagement. Many engagement escalation processes may also lead to selective disinvestment, blurring the boundary between these processes. We also report on the legal perspective, drawing out a fiduciary duty focus on ensuring the best return for members, in light of the set risk appetite – and provide a case study on the investment implications for a LGPS investor, which shows that the impacts of divestment could be significant in terms of risk, return and diversification.

Some possible considerations of next steps that investors could take include:

- Investing in the best interest of members requires an understanding of the **collective beliefs of the investment committee or Trustee Board** in terms of any response to climate change. For example, via a dedicated beliefs session. This will help determine the relative emphasis on engagement versus disinvestment or divestment, in the context of fossil fuels.

- Introducing and maintaining **climate risk frameworks and policies**. Detailed stewardship policies can inform climate-related stewardship activities undertaken by investment managers on behalf of the investor – and this should include a key focus on escalation guidance, to identify the thresholds to move between voting, engagement and disinvestment activities, in the context of climate change. The setting of climate-related expectations could also form part of the process of setting stewardship priorities, with detailed letters to managers on expectations.

- Ongoing **assessments of investment managers' climate-related capabilities and processes**, to inform the selection and retention of managers. This should include some ongoing monitoring of the credibility of investee companies, assets and governments' transition plans, by the investment managers, to identify the winners and losers in the transition.

- Ramping up **public reporting**, for pension members or stakeholders to better understand all the climate-related actions being taken by the investor. The development of TCFD reporting is an important step in this direction.

Please get in touch if you would like to discuss any of the above potential actions which we can assist with, or if you would like to have a conversation on any of the issues raised in this paper.

Appendix: Definitions

We set out below an overview of the definitions used in our analysis, albeit unfortunately, there are few standard definitions for many of these terms.

Fossil Fuel Exclusions

With no industry standard definition, we adopt the following definitions in relation to fossil fuel exclusions. These seek to differentiate between the driving forces that bring about an absence of investment in fossil fuels within a portfolio.

Divestment: Divestment is defined as a situation where the owner of assets commits to a blanket removal of a specific investment class from the investable universe. This can include the complete removal of a set of companies, sectors or regions with the intention to fully remove exposure from the undesired risk (in this case fossil fuel exposure). This ensures no material exposure will be permitted within the portfolio, either on a temporary or long-term basis. The divestment of the specific investment class is often undertaken to demonstrate adherence to sustainable finance practices and climate risk management.

Disinvestment: The specific investment class remains part of the investable universe, but an active decision is taken to completely sell down or reduce exposure for financial reasons. For example, the asset owner may disinvest from a company deemed to have an inadequate approach to managing climate risk – whilst this is removed from the portfolio, it remains in the investable universe, such that if climate risk management is improved in future, the asset owner could choose to invest again. Disinvestment may remove fossil fuel exposure through engagement escalation, to (at least temporarily) sell out from a particular name, should engagements with the company not yield the required outcome from an engagement perspective.

Exclusions: Fossil fuel exclusions are defined similarly to divestment. Exclusions are often (but do not need to be) more granular than a blanket fossil fuel sector divestment. For example, investors could opt to exclude just *select* fossil fuel companies, such as thermal coal companies, or those fossil fuel companies which undertake unconventional fossil fuel exploration, extraction and production (e.g. from oil sands or the arctic region).

From the **materiality perspective**, thresholds applied help to understand the point at which investors deem fossil fuel exposures to become material. In this report, we draw on the Institutional Consultants Sustainability Working Group (ICSWG)'s delineation of ten percent of investee company revenues.[66] Looking to real asset exposures, disclosures may instead need to focus on the proportion of the fund exposed to fossil fuels (drawing on the European Union (EU) Sustainable Finance Disclosures Regulation), and for example, whether this exceeds ten percent of the fund's investments.[67]

[66] Institutional Consultant Sustainability Working Group (ICSWG). (2021) *ESG Metrics – November 2021.* PowerPoint Presentation (icswg-uk.org)
[67] European Securities and Markets Authority, European Banking Authority, European Insurance and Occupational Pensions Authority and Joint Committee of the European Supervisory Authorities. (2021) *Final Report on Draft Regulatory Technical Standards.* jc_2021_03_joint_esas_final_report_on_rts_under_sfdr.pdf (europa.eu)

Stewardship

Active ownership: the use of the rights and position of ownership (either via debt or equity investments) to influence the activities or behaviour of investee companies. Whilst active ownership can be applied in each asset class, the avenues to do so will differ. For example, in listed equities, it includes engagement and voting activities, whilst for debt the focus is on engagement.[68]

Engagement: is a "purposeful, targeted communication with an entity (e.g. company, government, industry body, regulator) with the goal of encouraging change at an individual issuer [level] and/or the goal of addressing a market-wide or system risk (such as climate)"[69] via a range of approaches and methods. This definition is taken from the ICSWG definition, where the focus is on climate change engagement. Regular communication to gain information as part of ongoing research, however, is not considered as engagement (although it is worth noting some managers would classify this as such).

Escalation: Investment managers typically have stewardship escalation processes in place, including on climate change matters. This is a process: starting from voting activities, to bring about changes in investee firms for which they own equity holdings; to engagement activities, including the setting of specific engagement key performance indicators to measure progress. Many investment managers may use the threat of disinvestment as part of their escalation process if companies are not engaging with them.

Stewardship: We define stewardship as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society", in line with the definition provided by the Financial Reporting Council's 2020 UK Stewardship Code.[70]

Other Definitions

Fossil fuels: Fossil fuels result from decomposing animal and plant matter. Fossil fuels include coal, oil and gas fuels. Coal is the most carbon intensive fossil fuel, upon burning, whilst natural gas is the least carbon intensive.[71]

Just transition: The just transition is a process of greening the economy, in a way that is fair and inclusive, with respect to everyone concerned, creating decent work opportunities, and leaving no one behind.[72]

Greenhouse Gas (GHG) emissions: GHG emissions are released into the atmosphere as a result of the burning of fossil fuels, primarily from energy, transport and industrial or manufacturing processes.

Low carbon transition risk: Low carbon transition risk arises from companies realigning themselves from high to low carbon goods and services. Risks arising from the transition include climate-related regulatory developments, market trends and decarbonisation action.

Net zero emissions: A state where the GHG emissions released into the atmosphere are balanced out by the removal of GHG emissions back out the atmosphere (e.g.

[68] Principles for Responsible Investment. (2018) *Introduction to active ownership in listed equity*. Introduction to active ownership in listed equity | Technical guide | PRI (unpri.org)
[69] ICSWG. (2021) *ICSWG Engagement Reporting Guide Version 2: introductory guidance*. Firm-level questions. b25a61_2f1090f92f30484590358785cd7a3a34.xlsx (live.com)
[70] Financial Reporting Council. (2020) *UK Stewardship Code*. Stewardship-Code_Dec-19-Final-Corrected.pdf (frc.org.uk)
[71] ClientEarth. (2022) *Fossil fuels and climate change: The facts*. Fossil fuels and climate change: the facts | ClientEarth
[72] International Labour Organisation. (2023) *Climate change and financing a just transition*. Climate change and financing a just transition (ilo.org)

using nature-based approaches, such as reforestation, or man-made technologies, such as carbon capture usage and storage).

Stranded assets: Stranded assets will no longer be able to generate an economic return (before the end of their economic life) due to changes in market preferences (e.g. falling costs of low carbon technology) and regulatory environment (e.g. decarbonisation policy and carbon pricing).[73] Whilst partial stranding is where assets will start to generate returns below anticipated levels. They will result in unanticipated devaluations or conversions into liabilities.[74]

[73] Carbon Tracker Initiative. (2017) *Stranded Assets*. Stranded Assets - Carbon Tracker Initiative
[74] Caldecott, B., Tilbury, J. and Carey, C. (2014) *Stranded Assets and Scenarios*. Microsoft Word - Stranded Assets and Scenarios - Discussion Paper - 27.01.14.docx (ox.ac.uk)

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This paper predates the recent FCA anti-greenwashing regulatory changes effective from 31st May 2024.