

Local Authority Investments: Considerations about Climate Change including Fossil Fuels

Purpose of this briefing: There is a disconnect between local authorities declaring a climate emergency and continuing to hold investments which contribute to climate change, such as holdings in fossil fuel companies. Several medical organisations and Royal Colleges, including the Faculty of Public Health, have committed to fossil fuel divestment.

Directors of Public Health are often asked about **reducing local authority investments in fossil fuels**, particularly around divestment of local government pensions, in the same way as they may have been questioned about disinvesting in the tobacco industry in the past.

This briefing has been prepared for **Directors of Public Health** across Yorkshire and the Humber, as part of ADPH YH led work on climate change. The paper is intended to support Directors of Public Health to have conversations in their places around sustainable investment practices in their leadership roles.

Key points:

- **Reducing investments in fossil fuels is required to meet climate targets such as those set out in the Paris Agreement**
- **There are limited green/sustainable banking options for local authorities – the advocacy role of local authorities is, therefore, important in this space**
- **The nature of local government pension schemes makes it difficult for a single local authority to act to reduce pension investments in fossil fuels (e.g., through divestment or engagement)**
- **All Local Government Pension Schemes should assess, manage and report on climate-related risks – this may become a legal requirement**
- **Public health teams within local authorities should collaborate to influence change and hold their Local Government Pension Scheme to account**

1. Banking and Holding Funds

Local authorities hold funds in a variety of ways (e.g., in a bank accounts, through short term investments).

The organisation(s) which local authorities choose to bank with are important. The majority of a bank's assets are invested by the bank into a variety of vehicles such as business loans and government bonds. This can, and generally does, include the financing of projects which contribute to climate change. [Lloyds](#) and [HSBC](#) have committed to not directly financing new oil and gas projects/developments, but they may indirectly finance fossil fuels through lending to companies.

The “big four” banks in the United Kingdom (HSBC including First Direct, Barclays, Lloyds Banking Group and NatWest) are [estimated to have financed US\\$117 billion](#) to oil and gas expanders, mainly indirectly, between 2016 and 2017.

The two largest “mainstream” lenders in the UK with strong environmental, social and governance (ESG) credentials are the Co-operative Bank and Nationwide Building Society. The Co-operative Bank do not invest in fossil fuels and take additional steps to support [sustainable development](#), although around 25% of their shares are held by US hedge funds,

which may not invest profits sustainability. Unfortunately, the Co-operative Bank [withdrew services to local authorities](#) in 2013. Nationwide is a building society and therefore owned by its members rather than shareholders. While they do offer a [commercial savings account](#), they do not currently offer commercial current accounts. Triodos Bank is a smaller lender which has been voted the Best Ethical Financial Provider at the 2023 British Bank Awards. They do not invest in industries which could be perceived as unethical, such as weapons manufacturing or fossil fuels. They also provide transparency about all their investments, so it is clear which projects they are supporting. Unfortunately, however, like the Co-operative, they [no longer offer current accounts](#) to business customers.

In summary, banking with a green and sustainable bank sends a strong message from local authorities about their commitment to tackle climate change. At present, however, **limited sustainable and green banking options exist for local authorities**. Progress in this area is only likely to come from the main banks changing their investment policies, or banks such as the Co-operative Bank engaging in local authority banking. **Local authorities have an important advocacy role in this space** and there may be opportunities to pursue this through network organisations such as the LGA and SOLACE.

2. Pensions

The primary role of a pension scheme is to make money to pay members when they retire. Pension schemes have a “fiduciary responsibility” to their members. This is often considered purely a financial responsibility, however it is [becoming more common](#) to consider environmental, social and governance (ESG) issues as part of this. ESG incorporates a range of factors, such as the working conditions of the company or organisation being invested in, which includes a focus on sustainability and the impact of climate change. [Legal advice](#) to the Local Government Association (LGA) states that the price choice of investment by a pension scheme may be influenced by ESG factors, as long as this does not risk material financial detriment to the fund.

2.1 How do Local Government Pension Schemes (LGPSs) work?

Each **local government pension scheme (LGPS)** has members from multiple employers, including local authorities and other organisations who choose to participate e.g., the fire service (see Figure 1). Each LGPS covers a footprint across multiple local authorities. Each [LGPS](#) will have a Pension Board, which deals with the governance and administration of the fund, as well as a Pensions Committee who make arrangements for investments and management of the fund. The Pensions Committee is likely to include elected members from the relevant local authorities.

In 2016, the Government announced that [all LGPSs needed to join an investment pool](#) with the aim of reducing administrative costs and improving investment returns. [By 2025](#), each LGPS should have pooled at least 95% of their assets. There are currently [8 investment pools](#) across England and Wales. Each has been set up and managed differently, with very different governance structures. In Yorkshire and the Humber, there are four LGPSs which belong to two investment pools:

- [East Riding Pension Fund](#), [North Yorkshire Pension Fund](#) and [South Yorkshire Pensions Authority](#) are all in the [Border to Coast](#) investment pool (making up 3 of the 11 LGPSs involved).
- [West Yorkshire Pension Fund](#) is part of the [Northern Pool](#) (along with Greater Manchester and Merseyside).

Each pool holds a variety of assets, broadly grouped into the following asset classes: fixed income securities (such as bonds), equities (stocks), infrastructure, and cash. The pool will then have [a number of funds for each asset class](#), which are managed by fund managers who may be internal to the pool or external. Internally managed funds may still have some elements of external management (e.g., though holdings in investment management companies).

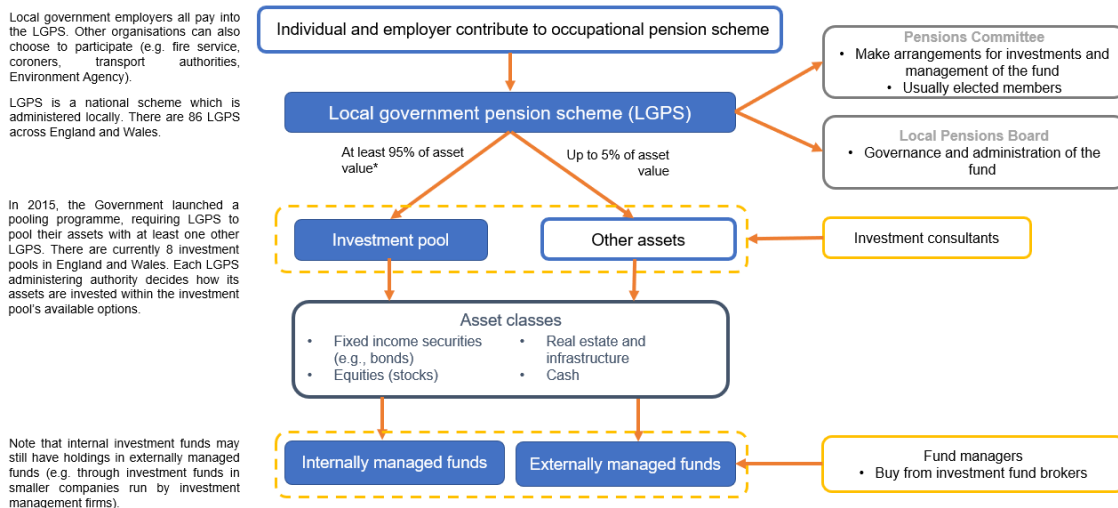


Figure 1. The structure of Local Government Pension Schemes and investment pools.

The structure of the LGPS, including pension schemes, makes it difficult for one local authority and/or one LGPS to act alone. In order to make a change to any LGPS strategy/policy, the majority of members of the LGPS pensions committee (who are likely to come from multiple local authorities) must agree. In addition, to then influence any policy or strategy at a pool level, the majority of members of the pool must agree.

2.2 Considerations around Climate

There are a range of options available to invest more sustainably including divestment, tilting, runoff, engagement and re-investment in climate mitigation measures. These are not mutually exclusive. Different options may be preferable for certain asset classes. For example, there may be more opportunities to [leverage companies selling bonds](#) because investors can refuse to refinance debt unless the company meets certain conditions, such as being aligned with the Paris Agreement. All options should be considered as part of wider climate change, ESG and investment strategies for each LGPS and investment pool.

2.2.1 Divestment

Divestment is where the investor sells off a portion of their assets (e.g. stocks, bonds), the opposite of investment. In the context of pensions, this is often considered to be divestment from fossil fuel companies (e.g., Shell, BP, ExxonMobil). There are a range of arguments which have been outlined both for and against divestment.

Arguments for divestment of fossil fuels

Moral: There is a strong moral case for divesting from fossil fuels based on the belief that it is wrong to profit from actions which will damage the health of the planet and the people living on it, particularly when countries which have contributed the least to climate change are likely to be disproportionately affected by its effects. There are [three interlinked arguments](#) in favour of divesting from fossil fuels:

1. Investing in fossil fuels contributes to grave, substantial and unnecessary harm and injustice
2. Divesting from fossil fuels helps to fulfil our moral responsibility to promote climate action
3. Investing in fossil fuels morally tarnishes those who do so making them complicit in the injustices of the fossil fuel industry

Repeated public divestment from the fossil fuel sector, or specific fossil fuel companies, can result in stigmatisation of these companies, helping to change the narrative around fossil fuel usage. A [report](#) by the Smith School of Enterprise and the Environment at the University of Oxford stated that “the outcome of the stigmatisation process poses the most far-reaching threat to fossil fuel companies. Any direct impacts pale in comparison.” Outcomes of stigmatisation can include difficulties working with contractors and the government, cancellation of contracts and mergers, and a permanently reduced company stock price. In addition, previous divestment campaigns (e.g., tobacco, South Africa) were associated with the introduction of more restrictive legislation.

The carbon bubble and risk of stranded assets: In order to meet the 2015 Paris Agreement pledge, [60% of oil and gas reserves and 90% of coal reserves need to remain underground](#). Currently, stocks in the fossil fuel sector are [valued based on the assumption](#) that they will be able to take all of their reserves out of the ground and burn them. In the future, it is likely that these reserves will not be burned as society shifts toward a lower carbon economy. The ‘[carbon bubble](#)’ will burst and [assets will become ‘stranded’](#), meaning that investors will not be able to recover their investment cost as intended. This becomes more likely as [carbon policies become more restrictive and/or renewable energy sources become cheaper and more efficient](#). This means that long-term investment in fossil fuels would be considered risky, particularly for pension funds which are [considered to be substantially exposed](#). Even organisations which do completely divest from fossil fuels, however, may be affected by a bubble bursting, as this could result in a [widespread financial crisis](#).

Generally, there appears to have been a shift away from coal and oil/tar sands (a mix of sand, water, clay and bitumen, which is used to make oil) rather than oil and gas companies. While [oil/tar sands are considered to be particularly polluting](#), the reason behind this is likely to be financial. It is unlikely that the goals of the Paris Agreement will be met without [phasing out coal](#) (for example, the phasing out of coal-fired power plants) and tar sands; thus there is a higher risk of stranded assets than with oil and gas.

Limited impact on pensions: There is a concern that divesting from a class of securities (such as energy/fossil fuels) can impact negatively on pension funds, through limiting diversification of portfolios. Recent studies, however, suggest that divestment from fossil fuels has a limited impact on portfolio returns, either performing in a similar manner to portfolios containing fossil fuels (e.g., [Plantinga and Scholtens](#), [Trinks et al.](#)) or even outperforming them (e.g., [Henriques and Sadorsky](#), [Bessa](#)).

Arguments against divestment of fossil fuels

Limited impact on greenhouse gas emissions: The evidence around whether divestment from fossil fuels has any impact on greenhouse gas emissions is mixed. Theoretically,

divestment [could reduce greenhouse gas emissions](#) as selling off investments may disrupt financing mechanisms for fossil fuel companies, meaning their assets stay in the ground. It appears, however, that money resulting from divestment in fossil fuels is often moved to another [fossil fuel company abroad](#) or to another sector with relatively high carbon emissions. Some research suggests the majority of funds would go the [financial sector](#), which as stated, can be used directly or indirectly by banks to support fossil fuel projects. There is some evidence that [divesting from energy and utilities](#) may have a greater impact on greenhouse gas emissions than divesting from fossil fuels.

Shifting the market share to nationalised companies: National governments [own 50% of fossil fuel production and up to 70% of oil and gas production](#), though companies which are either partially or entirely owned by the government (e.g., Saudi Aramco, Rosneft, Sinopec). There is an argument that if divestment does result in publicly traded fossil fuel companies going bust, this [simply increases the market share of these nationalised companies](#). Unlike publicly traded companies, these organisations are not beholden to shareholders and thus there are fewer opportunities to influence company policy and actions around climate. There are concerns about the performance and strategies of these companies, with The National Resource Governance Institute [highlighting issues](#) around corruption, mixed mandates, weak and uneven reporting, sparse research, and an absence of publicly available comparative data.

Assets (e.g., stock) will be picked up by neutral investors: In the short term, it is likely that any divested shares will be picked up by others, who may be 'neutral/climate-indifferent investors'. Currently, these investors have a [vested interest in ensuring that fossil fuels continue to be used](#), again especially in the short term, to maximise their profit from the asset. Divesting may therefore make a scheme or pool investment portfolio look significantly better in terms of carbon emissions but may not have made any real-world change.

Encourages large fossil fuel companies to sell off physical assets: Pushes for divestment may mean that large companies such as Shell and BP try to offload some of their assets so that the company is considered greener/more sustainable. These assets (for example, a coal mine) may then be picked up by another company; again this means that there is no change to real world emissions. Additionally, the new owners may be [private companies without shareholders](#), meaning that investors lose their ability to influence the company's actions.

Other 'sin stocks': [Sin stocks](#) are "publicly traded companies which are involved in or associated with an activity which is considered unethical or immoral." Fossil fuels may be considered a sin stock, along with other stocks such as alcohol and tobacco. These stocks are held because they [have higher returns than comparable 'non-sin' stocks](#), which benefits the investor. Many of these sin stocks have experienced [similar divestment campaigns](#) and [some funds will choose to screen/exclude such stocks](#). Note that these campaigns were opposed by commercial influences (e.g., tobacco divestment opposed by [Philip Morris](#)), thus the impact of commercial actors must also be considered in the fossil fuel divestment debate. There is an argument that if there are calls for divestment, it should be wider than fossil fuels and take a broader approach to sin stocks, rather than 'singling out' fossil fuels.

Ongoing fossil fuel use and other carbon-intensive industries: Some argue that a focus on divesting from fossil fuels [neglects the systemic nature of emissions](#), with almost all individuals partaking in activities and systems which can consume fossil fuels directly or indirectly (e.g., heating, cooking, using electricity, food system). This includes industries which would be considered carbon-intensive; [cement production](#), for example, is responsible for around 4-8% of carbon emissions. Some therefore argue that divestment does not address the fundamental issue of ongoing fossil fuel usage and greenhouse gas emissions, as even if investors then divest from fossil fuel companies they [cannot commit to forgoing all services or produce made using fossil fuels](#).

Effect on the global south: The Global South is [disproportionately affected by climate change](#). Some argue, however, that [divestment could make this worse](#). The argument is that if pension funds sell equity to neutral/indifferent investors, these investors may then choose to finance fossil fuel projects in low- and middle-income countries. This then shifts more of the burden of climate change mitigation, as well as the associated risk of stranded assets, away from high-income countries to those low- and middle-income countries.

2.2.2 Reinvestment

Reinvesting means allocating funds **to greener alternatives** to fossil fuels, such as renewable energy sources. Funds which focus on this type of investment may sometimes be described as a 'climate opportunities' fund. The magnitude of these investments is often much smaller than the fossil fuel assets which are managed by pension funds.

One important aspect to consider in terms of reinvestment is that there is [no fixed definition for what might be considered green or sustainable](#). For example, green funds could include carbon intensive activities such as the financing of a new airport.

Additionally, it is likely to be harder to get buy-in from investment pools or fund managers. Generally, green/renewable alternatives may be seen as relatively risky investments, particularly in the long term. This is the case for [several reasons](#) including the risk of price volatility and the risk of lower revenues due to unexpected curtailment. [Curtailment](#) means unexpected, uncompensated reductions of power production or consumption (e.g. grid bottleneck). Also, in the UK, there is a 'grid queue' meaning that new solar and wind sites are [waiting up to 10-15 years](#) to be connected because of a lack of capacity within the UK's electricity system. In addition, other risks include policy risks (e.g., a retroactive change to taxation), resource risk (e.g., risk of lower revenues due to inaccurate estimation of wind speed) and technological risk (e.g., higher maintenance costs due to novel technology).

Funds can also be invested in renewable **natural capital**, which includes "certain stocks of the [elements of nature that have value to society](#), such as forests, fisheries, rivers, biodiversity, land and minerals." Natural capital [could contribute about 30% of the climate mitigation needed to reach the Paris Agreement target](#). Loss of natural capital has a range of both financial and non-financial risks. Investors, however, can take account of natural capital, including [specific allocations to projects that establish, preserve, protect and enhance it](#).

2.2.3 Tilting

[Tilting](#) means that, within each sector, investors hold more stock in companies who are considered leaders/'best in class' in terms of sustainability and carbon emissions, and less stock in companies who are considered worst in class. Investors would therefore still hold stocks in oil and gas companies as part of their portfolio [but would have more money held in those changing the fastest and less money in those which are changing more slowly](#). The aim of this is to create incentives for slow changing companies to change direction or improve their practice to become more like the better performing companies. The value of tilting is that it works across a range of sectors, because all will have better/worse performers from a climate perspective. The disadvantage, however, is the need to regularly reassess weighting decisions, which can be difficult and relatively time intensive.

2.2.4 Run Off

[Run off](#) means that assets with a finite term are not replaced as they mature. In the context of fossil fuels, [examples](#) including holding a fossil fuel company's debt to maturity and then not renewing the loan, or operating a physical asset until it is no longer useful, resisting investing

improvements which would make the asset more productive or longer lived. It can be paired with divestment, for example, divesting to a company who are committed to running off the asset.

2.2.5 Engagement

[Engagement](#) is used to describe “interactions between the investor and current or potential investees on ESG issues”. For equities, the idea is that the investor can **influence change as a shareholder** of a company, for example, by writing letters, introducing shareholder resolutions, and voting on shareholder resolutions. For bonds, there are no shareholders involved but investors can choose to sell off some or all of the bond and not buy any more. Engagement is the preferred option for all LGPSs in Yorkshire and the Humber, including both Border to Coast and the Northern Pool. These engagement activities may be outsourced. For example, Border to Coast has selected [Robeco](#), the international asset management company, to perform its voting and engagement services.

Investors who choose engagement should have a clear plan or structure to their engagement activities, including when to move on or escalate to the next step/stage. Ideally, engagement should always be accompanied with divestment as the final end point if all attempts to engage fail, otherwise this engagement won't carry weight. Where any divestment does occur, it should be publicly stated that the divestment had happened due to climate risk.

Engagement (as with tilting) is often used in conjunction with calculating the carbon emissions for a particular company/portfolio/asset class. There are some difficulties with this approach. For example, the availability and/or quality of data can be lacking for some asset classes e.g., bonds. In addition, there is limited scope 3 emissions data, which calculates the indirect emissions of a company (for example, purchased goods, investments) which may make up a large proportion of the company's emissions. Furthermore, there are multiple methodologies to calculate emissions, so investors may use multiple different methodologies which give different results. There are some organisations who help to support this. The [Institutional Investors Group on Climate Change \(IIGCC\)](#) provides support around carbon methodologies, in addition to wider support and guidance to pension funds, asset managers and companies.

There are some noted downsides to engagement. Firstly, the costs (financial and resource) fall primarily on the investor rather than the company. In addition, even combined, the proportion of shares held by LGPSs may be too small to make a difference when acting alone (for example, all LGPSs across England and Wales may hold a combined 1% of a company). This is where initiatives like [Climate Action 100+](#) may have value. Climate Action 100+ brings together multiple investors across multiple sectors to engage with companies as a group. The Church of England, for example, is the lead investor for engaging with Shell.

It is difficult to measure the success or impact of engagement. There is limited academic literature which focuses on this. There are some examples of success, including the [hedge fund Engine No. 1](#), which campaigned to replace four members of ExxonMobil's board of directors despite holding just 0.02% of shares, and [successfully won three seats](#). This still, however, required a lot of money and support from other shareholders (who were mainly convinced due to financial concerns around stranded assets).

Some argue that engagement may work better when fossil fuels are not part of the core business model, for example, in the carbon-intensive aviation industry.

3. What does this mean for local authorities?

Given that we need a rapid phase out of fossil fuels to achieve net zero, local authority funds should not support fossil fuel investments. It is challenging, however, for an individual local authority to reduce their investments or completely divest from fossil fuels via their pension schemes due to the pooled nature and the complexities described in this paper.

Ideally, all local authorities should have a climate change strategy which directly references local authority investments in fossil fuels and supports a move away from investments in fossil fuels, whether this is through divestment and/or other means. Local authorities should support their LGPS to create a similar document. The Government launched a [consultation last September](#), seeking to determine whether LGPSs should assess, manage and report on climate-related risks in line with the recommendations of the Taskforce on Climate-related Financial Disclosures. It has [recently been confirmed](#) that any recommendations would not come in to force prior to April 2024.

In addition, there are a series of other actions which local authorities can undertake:

1. Hold discussions with **elected members** on the local pensions board to discuss the climate risks of the pension scheme's investments and ways to potentially mitigate this.
2. **Ask questions** of the LGPS, focusing on what their climate change strategy is and how they monitor and evaluate any progress against this.
3. **Collaborate with other local authorities** to build consensus and jointly influence the local LGPS and the wider investment pool.
4. Push for **investment in sustainable funds and/or natural capital**, ensuring that the LGPS and investment pool have sufficient opportunities for this.
5. Recognise that LGPS and investment pools are **likely to continue with engagement** as a strategy. Where this is the case, push for clear details about what the steps in this process are and more granular data on **reasoning and outcomes of all decisions**, rather than a quarterly or annual summary.
6. **Comment on national strategies** related to investments in fossil fuels (for example, provide support to strategies which would make certain targets mandatory or force companies to change behaviour). This should not just be around pensions but include *broader financial regulation* and other ideas such as a *carbon tax*. Within this, it is also important to support strategies which encourage investment in carbon mitigation.
7. **Collaborate** with other local authorities, the LGA and SOLACE to advocate for more sustainable banking options to be open to local authorities.

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