LGIM's Climate Impact Pledge: The results so far

We are publicising the global corporate leaders and laggards on climate change.

Meryam Omi is responsible for engaging on sustainability themes globally and the development of responsible investment solutions.

A year ago, we had a clear message for the companies in which we invest: ignoring climate change is a financial risk. We would use our rights as major shareholders to put pressure on them to help accelerate the transition to a low-carbon economy.

We called this our Climate Impact Pledge – a commitment to engage with 84 of the world's largest companies, alongside analysing, scoring and ranking them against their peers to improve their strategies to address this challenge.

As part of the process, we also said LGIM would make public the names of some of the best and worst performers, alongside examples of best practices that we would like to see adopted more widely.

One year later, we are seeing many companies taking positive steps. From banks to oil and gas producers, businesses are responding to our demands and embracing the advantages of sustainability. This reinforces our belief in the value of engagement, which is core to our role as a steward of our clients' assets.

In this piece, we are 'naming and faming' those companies that are indeed excelling in taking real, positive action to meet one of the defining challenges of our era; we also highlight those where there is significant room for improvement.

NO 'TRUMP BUMP' FOR CLIMATE PROGRESS

Since we began the engagement process in April 2017, our scores for US companies have improved, dispelling concerns over the knock-on effects of President Donald Trump's decision to withdraw from the Paris climate accord.

Average Japanese, Australian and South Korean companies have also climbed in our rankings; by contrast, average French, UK and German companies declined. These trends reflect a broader increase in Asia, and a slowdown in Europe, in clean energy investments last year[1].

Back in 2017, more companies' scores were towards the bottom than the top of our initial ranking; one year later, however, we have seen improvements in the scores of *entire sectors*. This was true of oil and gas companies, utilities and auto manufacturers. These sectors are on the front line of the energy transition, as companies react to the plunging costs of renewables and the rapid rise of electric vehicles.

TIME FOR ACTION

The energy transition is fast becoming a sustainability revolution, which we believe can transform all areas of the economy, from food retail to banks. Through the 2015 Paris Agreement on climate change, countries around the world have set themselves the target of keeping the average rise in global temperatures to "well below" 2°C above pre-industrial levels. The companies covered by the pledge are in sectors that we believe will be crucial to meeting this target.

1 BNEF Clean Energy Investment Trends, 2017

Legal & General INVESTMENT MANAGEMENT

Figure 1: The Climate Impact Pledge - our process

When we began the pledge, we wanted to encourage companies to address material climate risks and opportunities. The transition to a low-carbon economy will have many winners and losers, so companies need to plan ahead.

Time is critical, so we also wanted to encourage a sense of responsibility beyond the balance sheet. There are no winners in a world of rampant climate change and forced migration, where vast stretches of earth are rendered uninhabitable[2]. To avoid this, we need a more inclusive form of capitalism, and we need to think about the future, now. Otherwise, companies will likely fail in their duty to deliver benefits to society, not just to investors. Luckily, many companies are well-placed to take meaningful action, as their operations cover the globe and their plans span decades into the future. This is why we believe our engagement is more important than ever.

IN-DEPTH ANALYSIS OF RISKS AND OPPORTUNITIES

We expect companies to be transparent about the risks and opportunities posed by climate change, and their lobbying activity to be consistent with official company positions. We want companies to have a credible low-carbon strategy and a board that is capable of implementing it. We have developed these principles into a proprietary methodology with over 50 indicators, which give us a well-rounded view of companies.

This analysis helped us to formulate clear and measurable objectives that we, as shareholders, want these companies to achieve. When we launched the pledge, our **accompanying article** made it clear that we expect companies to keep up with the best practices in their sector – as, indeed, many are now doing.

COMPANIES STEPPING UP

Across all our categories*, we have found companies taking the lead and companies that are fast catching up.

Category*	Leaders	Significant improvements since 2017
Statement on climate change	Nestlé	Daimler AG
Transparency	Statoil, Bank of America Merrill Lynch, BNP Paribas	Kraft Heinz
Board governance	BHP Billiton	Toyota
Business strategy	Total	Commonwealth Bank
Public policy	Iberdrola	EDF

*Please see the appendix for further detail on these categories

2 Mark Lynas, *Six Degrees: Our Future on a Hotter Planet*, 2008

Case study: Total, a leader in business strategy

Oil and gas major Total has stated that it will put a climate-compliant 2°C scenario at the centre of its strategy. Having already made significant investments in clean energy and battery manufacturers, the company will increase its focus on renewables and natural gas. The ultimate goal is for the company's product mix to represent a smaller-scale snapshot of how the global energy system itself must look like in a 2°C world.

Case study: BNP Paribas, a leader in transparency

The biggest listed bank in France, BNP Paribas, discloses the carbon content of the power plants it finances. It also plans to reduce this in line with the global averages needed to reach the 2°C objective. The company has also recently announced that it will no longer finance the development of 'extreme' fossil fuels (coal, tar sands).

TARGET: ENGAGED!

It does not matter if we invest in companies through active or index funds; what matters is that they do well. This is why we engage and vote using the assets in LGIM's entire equity portfolio. However, to be effective, engagement must have consequences.

We will vote against companies and are also making public the names of the best and worst performers in our ranking. We also have the threat of divestment from select funds as another means of sending a powerful message to companies.

Little wonder, then, that we had a high rate of response throughout our first engagement period: 74% of companies responded to our initial letters, resulting in meetings with 61% of the companies covered by the pledge. This process has indicated that engaging with companies does indeed help to keep pressure on them, which we believe contributes to positive decisions such as the following:

- The board of **Toyota**, the world's largest carmaker by market capitalisation, has endorsed the 2°C target of the Paris Agreement. The company has also announced plans to make all cars available as either electric or hybrid models by 2025, and has independently verified more of its greenhouse gas emissions.
- **Wells Fargo**, the US bank, has committed to invest $200 billion in climate action and sustainability by 2030.
- Australia's **Commonwealth Bank** has committed to phase out its lending to coal plants.

NEXT STEPS

When we unveiled the Climate Impact Pledge, as part of the first fund in the Future World range, we decided that companies which fail to meet our minimum standards after a period of engagement may be removed from the range.

The first round of engagement has now come to an end. Our activity has shown that while some companies are excelling in meeting the challenge posed by climate change, others are failing to do the bare minimum. A number did not to respond to our requests for any engagement; of those that did, some have only shown superficial signs of improvement, if any at all.

We outline below the companies that are divested from within our Future World range, due to their scores and their responses, alongside the rationale behind this decision.

- **China Construction Bank, *financials***
  - No response to our attempts to engage
  - Poor score in all sections
- **Dominion Energy, *utilities***
  - Poor scores, particularly for strategy and transparency
  - High exposure to high-cost coal plants
- **Japan Post Holdings, *financials***
  - No substantial improvements on any of our urgent/critical requests
  - Lack of basic climate disclosures
- **Loblaw Companies, *food retail***
  - Poor engagement with the company
  - Insufficient disclosures and targets
- **Occidental Petroleum, *oil and gas***
  - Poor scores in strategy and transparency
  - No plans to report total emissions
  - Lack of ambitious carbon targets
- **Rosneft Oil, *oil and gas***
  - No response to our attempts to engage
  - Poor disclosure
- **Subaru, *auto***
  - Poor disclosures, particularly around the business implications of the energy transition
- **Sysco Corp, *food retail***
  - No substantial improvements on all but one of our urgent/ critical requests
  - Lack of climate change policy

While there are other examples of companies that did not score well against our methodology, we consider that they have shown sufficient improvement in the last year to avoid the threat of divestment.

Your Future World

The funds in the *Future World* range have been designed to take advantage of the opportunities posed by the transition to a low-carbon economy. The first fund launched in this range, the L&G Future World Fund, tracks an index which 'tilts' away from high-carbon companies and towards companies with lower than average carbon emissions.

The index tracked by the Future World Fund has already reduced its exposure to the world's 200 most carbon-intensive companies by more than 50%, compared to a similar global equity index, the FTSE All-World. In 2016, these 200 companies emitted almost as much carbon as the United States.

SPEAKING WITH ONE VOICE

As the current Future World funds are index funds, we have set ourselves a tracking error limit within which divestment can occur. The tracking-error impact on the original Future World Fund of divesting from the companies listed above has been minimal: 1.5 basis points (0.015%) versus a maximum limit of 30 basis points.

Divestment clearly does not meaningfully alter the risk/return profile of the funds. But it does send a strong message to companies, putting pressure on them to be more resilient to the risks posed by climate change. We believe this approach is fully consistent with our fiduciary duty, and has the potential to lead to better financial outcomes for our clients over the long term.

Divestment is not a goal in itself, but merely a 'stick' with which to prod the industry forward. And, were the performance of companies to improve significantly in the future, they would be reinstated in the funds. In all other LGIM-managed funds where we cannot divest from a company, **we vote against re-electing the chair of its board**, to ensure we speak with one voice across all of our assets. For more details on the pledge and the divestment process, please visit our **website**.

INVESTING FOR THE FUTURE

Through our decision to engage, vote, divest if necessary and invest in the transition to a low-carbon economy, we are demonstrating that investors can and should do more.

The original Future World Fund increased its exposure to companies providing services for the low-carbon economy ('green revenue') by more than 90%[3] compared to the FTSE All-World Index. At already the size of the oil and gas sector[4], the green economy can only grow, and we want to support its growth.

The risks of climate change are real, and will have financial consequences. But there is no need for despair; there is much we can still do. As shareholders, we want to help companies along this journey[5]. The pledge has shown that engagement can be a powerful tool to achieve meaningful action. We also know our impact can be magnified through collaboration, so we continue to work with other investors[6] and governments[7] to help create a more sustainable financial system.

Over the next year, we will keep up our efforts to improve the companies in which we invest.

The more company scores go up, the higher the chance of temperatures *not* going up. Let us work to make this happen.

3 Compared to a similar global equity index - the FTSE All-World. Source: FTSE Russell data as at 31/03/2018.
4 FTSE Russell, Investing in the global green economy: busting common myths, 2018
5 http://www.lgim.com/files/_document-library/capabilities/lgim-acts-on-climate-change.pdf
6 http://www.lgim.com/files/_document-library/capabilities/open-letter-from-lgim-and-other-global-investors-to-the-oil-and-gas-industry-may-2018.pdf
7 https://www.gov.uk/guidance/green-finance

APPENDIX: MAJOR AREAS OF ASSESSMENT

Our analysis of companies involves the assessment of more than 50 indicators to generate a well-rounded view of a company's exposure to climate-related risks and opportunities. We explain our major categories below.

1. Statement on climate change

We look for a clear statement about the business risks and opportunities posed by climate change. In addition, we look for companies to acknowledge the goal of the Paris agreement, which sets a measurable limit on the amount of greenhouse gases (GHGs) emitted.

Leaders

Nestlé, the multinational food manufacturer, has set targets to reduce GHGs by 2020, in line with the Paris Agreement.[8] The company discloses these 2020 targets and how it is performing against them.[9]

Laggards

Russia's **Rosneft** has produced a sustainability report which does not mention "climate change" a single time in its 144 pages.[10] For investors, this provides little reassurance that the company is planning for a world that must use less of its main fossil fuel products.

2. Transparency

We can use coal power to charge electric vehicles and we can use solar power to extract oil: on their own, statistics about carbon reductions and resource usage might not capture the entire environmental impact of a business. This is why we look at how transparent companies are in their reporting and disclosures.

In the oil and gas sector, most of the GHG emissions do not come from drilling and transporting oil, but from burning it (so-called 'scope 3' emissions). In the case of a bank, lending decisions might completely offset the benefits of otherwise efficient operations.

Leaders

Norwegian energy company **Statoil** has been reporting its total emissions since 2014.

Bank of America Merrill Lynch has been publishing the carbon intensity of its US utility portfolio since at least 2012.

BNP Paribas, in France, for its carbon transparency and targets (as discussed on p. 3).

Laggards

Despite coal pollution reportedly killing more than 360,000 people in China in 2013[11], **China Construction Bank** remains the world's largest funder of coal mining and power plants.[12] While the company has increased lending to green projects[13], it does not disclose the total GHG emissions associated with its business.

3. Board governance

Our criteria for assessment include board skill-sets and independence, and the structure of the audit committee. They also reflect our voting history as shareholders: if a company has given us reasons to vote against it (e.g. concerning unjustified pay packages) it might well be lagging behind in other areas, such as climate change.

We have found recurrent correlations between governance and other metrics. The top-scoring companies in many of the other categories outperformed peers on the several measures of board diversity. This reinforces our belief in the importance of diversity of thought in senior leadership.

Leaders

We supported miner **BHP Billiton** in its recruitment process for a new chair of the board. Unusual for its sector, the company has publicly discussed "the growing regulatory and societal pressures"[14] that are making coal unattractive.

In addition to its announcements on climate change, we were pleased to see **Toyota** respond to our demands for more board diversity. The company has now appointed the first woman to its board.

Laggards

We have voted against reappointing the chairman of **CK Infrastructure Holdings**. We considered the company lacked sufficient levels of independence on the board, and its directors served in too many external roles.

8 Nestle, Annual Report 2017, p. 35
9 https://www.nestle.com/csv/impact/climate-change/climate-change
10 Rosneft, Sustainability Report 2016
11 https://www.nytimes.com/2016/08/18/world/asia/china-coal-health-smog-pollution.html
12 https://www.ran.org/bankingonclimatechange2018#grades-panel
13 'In 2017, CCB's green loan balance grew at a rate of 12.74%', China Construction Bank Corporation Corporate Social Responsibility Report 2017
14 BHP Billiton, Climate Change: Portfolio Analysis, 2015

4. Business strategy

Currently, the majority of corporate reporting is backward-looking, asking: what has the company achieved over the past year or the past quarter?[15] This does not allow for thought about the climate change challenges that lie ahead. We expect to see the state of disclosures improving, particularly after the recommendations of the **Task Force on Climate-related Financial Disclosures** (TCFD), which we supported. Until climate disclosures become the norm[16], we will conduct our own analysis to bridge this gap.

Scenario analysis is an essential tool in this process. Banks, for example, must have contingency plans against high-impact, low-probability scenarios such as a sharp increase in unemployment. Regarding climate, scenario analysis can illuminate the dynamic impact of shifts in technology, policy and consumer preferences. For example, we know that in a 2°C world, oil demand must peak and start to decline. Are oil companies planning for this eventuality? How will this impact their portfolio? As one energy executive said recently: "predicting price is useless but scenario planning is priceless."[17]

Leaders

Oil and gas major **Total**, for its 2°C strategy (as discussed on p. 3).

BHP Billiton has disclosed the earnings impact of various climate scenarios across the different sectors where it operates.[18]

The silent majority

In our analysis, more companies scored better on individual criteria relating to climate risks and opportunities, highlighting a need to join these up into a coherent picture. This is precisely the role of scenario analysis, which increasing numbers of shareholders and regulators are beginning to demand globally.

Companies can no longer claim (as we sometimes hear in our meetings) that increased disclosures will harm their competitive edge. If an oil major can publicly talk about oil demand peaking within less than a decade[19], there is no excuse for companies not to be forthcoming about risks and opportunities. It is the absence, not the presence, of disclosures that worries us as long-term investors.

Japan Post Holdings, for example, stands exposed to climate change risks through its insurance business. Yet we do not consider this reflected into the overall strategy. Our view is reaffirmed by an independent evaluation of insurers' response to climate change conducted by the Asset Owners Disclosure Project, where the company was ranked 68th out of 70.[20]

5. Public policy

What companies do matters a lot, but so does what they say – in particular, what they say to governments and regulators. This is why the pledge includes a category focused specifically on public policy and lobbying activity. Drawing on data from an independent provider, we track the strength of climate-related engagements and their direction. We judge whether climate change is salient for a company by the number of policy consultations, meetings held, membership of trade associations and media coverage. We also ask: is the company supportive, or obstructive of low-carbon policies?

Leaders

The Spanish utility **Iberdrola**, one of the largest electricity companies in the world, has called for ambitious EU emissions reductions and has lobbied for the EU to raise its carbon price[21] (a reform that is now underway). By going from being mostly fossil fuel-powered to having 60% renewable generation capacity in less than a decade, Iberdrola is 'walking the walk'.[22] It is also talking the talk, being ranked as a True Climate Policy Leader by InfluenceMap, our data provider for this category.

Laggards

The second largest utility in the US, **Southern Company**, has opposed emission standards and climate legislation in the US.[23]

15 To encourage long-term thinking, Legal & General Group has **abandoned** quarterly reporting. LGIM has encouraged its investee companies to do the same.
16 Legal & General will be publishing its first TCFD-aligned report later this year.
17 s3.amazonaws.com/prod-conocophillips/files/reports/2017_aim_website-deck-final.pdf
18 BHP Billiton, Climate Change: Portfolio Analysis, 2015, 2016
19 Both Statoil & Shell have made statements to this effect.
20 http://aodproject.net/insurance/
21 https://influencemap.org/report/Corporate-Carbon-Policy-Footprint-4274a464677481802bd502ffff008d74
22 Sustainability Report, 2017
23 https://www.unpri.org/climate-change/converging-on-climate-lobbying-aligning-corporate-practice-with-investor-expectations-/3174.article