City of Burnaby

Meeting 2020 October 14

COMMITTEE REPORT

TO:	CHAIR AND MEMBERS FINANCIAL MANAGEMENT COMMITTEE	**DATE:**	2020 October 07
FROM:	DIRECTOR FINANCE	**FILE:**	7500-20

SUBJECT: **ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) AND SOCIALLY RESPONSIBLE INVESTMENT (SRI) STRATEGY**

PURPOSE: To provide information about the City's investment portfolio related to Environmental, Social and Governance (ESG) and Socially Responsible Investment (SRI) strategy.

RECOMMENDATION

1. **THAT** the Financial Management Committee receive this report for information.

REPORT

1.0 INTRODUCTION

Environmental Social and Governance (ESG) and Socially Responsible Investment (SRI) strategies are being widely considered within the municipal environment, recently catapulted by numerous climate emergency declarations. The City of Burnaby commenced incorporating focused SRI products with the City's investment portfolio a few years ago and currently holds a Bank of Montreal SRI product as well as products within the Municipal Finance Authority of British Columbia (MFABC) Mortgage Fund and the Fossil Fuel Free Short Term Bond Fund.

This report will provide the Committee with information on ESG and SRI concepts and the City's investment portfolio and strategy, endorsed by Council, as it pertains to these respective concepts.

2.0 POLICY SECTION

Goal

- A Healthy Community
  - Healthy environment –
    Enhance our environmental health, resilience and sustainability

- A Thriving Organization
  - Organizational culture –
    Ensure that our core values are reflected in our policies, programs and service delivery
  - Financial viability –
    Maintain a financially sustainable City for the provision, renewal and enhancement of City services, facilities and assets

3.0 BACKGROUND

Since the mid-1970's, the relatively focused concept of investing in "ethical companies" or investing in "ethical funds" has more recently - in the last two decades - grown to include a plethora of products and investment vehicles that are considered "*green, ethical, environmental, socially responsible or that invest in entities that employ good governance practices*". Considered non-financial criteria, the concept today is commonly called socially responsible investing (SRI) which focuses an investor on the environmental and social effects of an investment.

The science and dialog around global warming and climate impacts of carbon emissions or other business practices has evolved (and accelerated) over time and this has been a catalyst in raising investor awareness about the companies they invest in and the various investment products available to them. In general, terminology relating to ethical investing has evolved into the acronym "ESG" - which stands for Environment, Social and Governance - referring to the three key factors when measuring the societal benefits and general sustainability of a company's operational "footprint" and performance.

Strategic portfolio investment into companies that meet the investor's identifiable goals or standards pertaining to its operations, products it sells and societal impact is a fast growing concept. While the effects of SRI or ESG investing can be difficult and challenging to quantify, investors can find various investment options through avenues such as mutual funds, exchange traded funds (ETFs) or through investment brokers that specialize in researching companies based on non-financial criteria such as social or environmental factors.

As a new industry, with a virtually unlimited number of ESG factors being analyzed, and uncertain and developing science used to determine the value proposition of each factor, the ESG landscape is extremely fractured with as many players as approaches to the process, with very limited standardization and comparability between products. The screening and other processes around investment selection varies dramatically between firms that create ESG products.

As margins on traditional investment products have been steadily decreasing over the years due to standardization and competition, and ESG investing has become a highly focused area, the investment industry has quickly capitalized on the unstructured and non-standardized nature of the space. The research and analysis needed to create ESG products has meant increased fees and higher management expense ratios which often translates into increased revenues for the structuring firms and sellers of these products. Until common disclosure standards are introduced, which may require government or global standard setters to introduce legislation and/or set global guidelines and legislation, the ESG space will remain very difficult to navigate for investors. The United Nations, as an example, introduced a set of guidelines called Principles of Responsible Investment (UN PRI) which is a list of possible actions for incorporating environmental, social and governance factors into various decision making process. While the goals are inspirational, they are however voluntary and must be tailored for each investor/organization, and they do not provide minimum requirements or a system of performance standards or measurement.

Defining, narrowing down and then navigating ESG principals into investment guidelines and a portfolio composition is an extremely challenging task that adds much complexity to the investment process, and if not done very carefully can often lead to unfortunate consequences. This can include negatively impacting a municipalities primary objectives of safety, liquidity and return on investments. Understanding the principals, its limitations and options when introducing SRI or ESG objectives does not mean there will not be detraction from the main objectives, but being aware is key when exploring investment alternatives.

The first step in deciding to incorporate ESG factors into the investment portfolio is to ascertain a “moral compass” and decide not only which of the myriad of factors are most important and can be incorporated into the investment process, but just as importantly which factors are more important than others. Investing is all about “optimizing” a portfolio to meet certain objectives and therefore it must first be decided what to optimize. So, a simple example, may be to choose several factors such as minimizing carbon footprint in the portfolio and excluding companies who extract or transport fuels; or not investing in “vice” companies such as alcohol, tobacco or gambling providers, both of which are exclusionary actions. An investor may consider not investing in companies that do not have at least a 25% female composition on the board of directors and 20% of female representation in senior management. But even if all the hundreds of ESG factors to choose from were looked at, next it must be decided which factor is more important than the other.

A follow on activity would be to come up with standardized ways for comparing companies in a dynamic world and where ESG disclosures are voluntary, often non-existent and certainly not done in a consistent fashion. Counting the number of women on a board may be easy, but Board composition changes all the time. If an investor is looking to minimize carbon footprints, a decision must be made to stop at the company’s own carbon footprint or start adding all the downstream uses of carbon that are inherent with using a company’s products.

There now is a widely accepted conviction that climate and other changes can be affected through financial tools. Exclusion of companies by an investor is a means of exerting pressure to enact behavioral or other changes. Using fossil fuels as an example, we all use the fuels and by products in our daily lives and Canada is considered a heavily resource based economy. Investment policy for a municipality must consider many variables, including that some taxpayers may want divestment while others may not as this may be an industry they are employed or receive large community benefits.

As a local government investor, once an assessment of the City's "moral compass" is attained and the realization that the city itself cannot possibly analyze and compare investments options on its own, a discussion about out sourcing these decisions can be looked at. With so many products now available, it is extremely challenging to wade through the marketing and other materials associated with each and to determine what investment parameters provide the best solution for the exclusionary or inclusionary type of investing available or to be designed. Or, which analytics company out of many, provides the best and most reliable and accurate measurement of compliance. Most notably, there are investment framework categories that are continuously reported on, such as "fossil fuel free", "socially responsible investing (SRI)" and "impact" investing" designed to simplify the selection process. But there are challenges to all ESG methods as there are varying standards globally.

In Canada for example, Federal and Provincial bonds are all considered ESG compliant investments as these are government lead initiatives within a modern and transparent country; thus meeting social, environmental, governance and many other prudent investment standards. Canadians and resident analytic firms would consider this debt for general ESG investing and specific funds such as SRI and fossil fuel free. For example, the MFABC Fossil Fuel Free Short Term Bond Fund, which excludes "companies involved in the extraction, production and transportation of coal, oil and natural gas" can hold Government of Canada and Province of Alberta Bonds. Yet, both the Government of Canada and the Province of Alberta directly own a pipeline and a tar sands upgrader.

Some investors outside of Canada, in contrast namely to some European Union countries, do not include Government of Canada bonds or Alberta Bonds as eligible for ESG branded investments. In fact, some investors exclude all Canadian Government Bonds as we are a very heavy carbon-intense economy. Canada is considered the worst ranking government on fossil fuel subsidies as stated by the UK Overseas Development Institute!

If an investor looks at Canadian banks as an ESG investment option, depending on the ESG criteria used, they may find that the banks do fare very well when considering the entirety of their lending portfolios. Financial institutions provide various mortgages and loans, primarily for residential and commercial properties which ensures social equality, opportunity and long term sustainable growth and wealth opportunity. A very strong argument for an SRI or fossil fuel free fund. However, some analysts have cautioned that Canada's top five banks also provide large loan facilities to companies in the fossil industry.

So even mutual funds and specific investment funds that maintain an ESG screening or standards policy, can be questioned when you consider the reach of investment dollars in a financial institution that has many lending avenues. The dynamics lead to the very question of the standards and criteria set for the investor.

4.0 CITY OF BURNABY INVESTMENTS

The Community Charter provides legislative guidelines for the guarantors the City invests in such as the Government of Canada, Provincial Governments, regional districts, the MFABC debt or pooled funds, other municipalities, banks and other financial institutions which includes credit unions. The Charter does not stipulate or provide guidelines on the credit quality of these institutions nor does it suggest standards related to social or responsible investing. The City of Burnaby maintains our own set of investment guidelines to maximum limits on institutions and to ensure diversification of holdings and risk mitigation.

Currently, the City's investment portfolio of $1.9 billion is invested in and guaranteed by the Government of Canada, the Province, MFABC, and Schedule I bank bonds as well as bank and credit union deposits. The deposits include fixed income securities and floating rate securities. As well, the City holds $30 million in MFABC pooled funds: the Mortgage Fund ($10 million) and the Fossil Fuel Free Short Term Bond Fund ($20 million), and staff are planning to add to these positions.

The City has not traditionally invested into MFABC funds, other than our initial enrolment in 1989 and the mandatory accompanying $1.00 deposit, but we have been slowly shifting funds recently to MFABC to take advantage of investment asset class diversification, sustainability funds and potential higher yields as the market has shifted dramatically since the MFABC Fossil Fuel Free fund inception. In addition, the MFABC Act provides for investment guarantors in the pooled funds for which the City cannot invest directly under the Community Charter. This spread yield allows for improved risk adjusted returns in the future.

While the City does not currently have a defined policy regarding ESG or SRI investments, the portfolio essentially invests in ESG products within the limitations of the Community Charter. The nature of the City's holdings in government and financial institution bonds and deposits would be considered a socially responsible investment portfolio under many standards. However, there are countries and investment funds whose screening and analytics excludes these same guarantors. Thus, the nature of the ESG world is one with varying standards, different methodologies, analytical variances and limited governance. When isolating British Columbia for example, the provincial and municipal governments, Burnaby included, derive annual income from casino operations. It is difficult to determine SRI or ESG guidelines in such a specific and prescribed manner when there are so many factors and areas of engagement, including citizenry who earn their livelihood from a plethora of different industries.

The City does not invest directly into fossil fuel free companies. However, the bonds and deposits that we do invest in through Federal, Provincial and Schedule I Bank debt, may lend and invest in industries and companies that include fossil fuel related activities. The City's investments are considered some of the most secure and socially responsible investments available. Providing deposits to or investing in a Canadian government entities both federal and provincial, Canadian banks and credit unions does not limit the use of those funds by that institution. As discussed, these institutions may offer various credit facilities to said companies. As an investor, setting a threshold or criteria for determination of which financial institution or government we invest must be easily measurable and transparent. However, implementing a blanket approach when it comes to selecting guarantors based on ESG criteria, can have risk adjusted limitations and unanticipated consequences. In addition, there are ongoing operating costs for analytic subscriptions.

5.0 MFABC ESG/SRI INITIATIVES

5.1 MFABC Fossil Fuel Free Short Term Bond Fund

In 2017, the MFABC was approached by several municipalities requesting the creation of an SRI pooled fund. The MFABC was not able to obtain commitments from enough investors to meet the minimum $100 million threshold needed to get the fund started. With only $60 million committed by a few municipalities – for which the City of Burnaby designated up to $20 million – initial and ongoing fund costs were prohibitive. Had the MFABC received sufficient funding commitments however, the next step and biggest challenge would have been defining the SRI initiatives and guidelines for the fund. This in itself would have proven to be a tremendous task.

In late 2019 however, the MFABC once again was approached by a few municipalities seeking a short term bond fund that would divest of fossil fuel companies. Based on this simple and seemingly defined approach while utilizing the relationship and expertise of Phillips, Hager & North (PH&N), the MFABC was able to significantly reduce startup and other costs while leveraging the screening model already in place. The MFABC Fossil Fuel Free (FFF) Short Term Bond Fund was created and went live in May 2020, utilizing the screening services from Sustainalytics and the Carbon Underground 200 list to direct the fund manager PH&N in screening out fossil fuel related companies. The fund therefore does not hold Petro Canada bonds for example, but does invest in Government of Canada and Provincial bonds based on the analytics reporting provided. This is some of the same entities the City directly invests in today. The fund however does hold corporate bonds, which the City cannot invest directly under the legislated guidelines of the Community Charter, but which the MFABC is able to invest in under the MFA Act.

While the City has invested $20 million in the MFABC FFF short term bond fund along with several other cities as a means of enacting moral guidance, diversifying asset class holdings and reducing various investment risks, fossil exclusionary investing means the removal of companies, even if they are transitory in their corporate activities and business model. This new MFABC fund is a good start in meeting the needs of many municipalities, but it may not be the best method for impacting climate change globally. And in fact, just recently the MFABC repositioned the former Intermediate Pooled Fund into a highly liquid government and major bank fund called the Government Focused Ultra-short Bond Fund, which is also considered to be Fossil Fuel Free. Thus providing municipalities with SRI and ESG related investment opportunities.

As noted, a fossil fuel free exclusionary lens is not the only way to invest. Adopting an "impact" ESG model for example, broadens the field of eligible companies as they are engaged with government agencies and shareholders; dedicated to working through a long term change to their business model. The process is to make substantial changes that impacts - for the positive - the companies profile when it comes to ESG criteria and reducing their carbon footprint as a company. This is achieved through engagement not exclusion for which there is not significant evidence showing that divestment of holdings is having any bearing on capital funding or revenue generation. In fact, an RBC survey in 2018 reported that 45% of respondents would prefer investments to be engaging and affecting change while only 8% wanted exclusionary investing to be the guiding measure.

5.2 MFABC – Sustainable Growth Fund (new)

While the City of Burnaby's investment portfolio over the last 20 years has performed well compared to our peers and benchmarks – 2019 yield of 3.16% (2020 projected 2.98%) – there are limitations to the risk adjusted returns available to the City. Yields are projected to remain low for several years to come, which will mean lower returns for the City. At the end of a three decade bond bull-run where globally interest rates are at all-time historical lows, ensuring diversification of investments to reduce risks while increasing returns is critical.

At the September 2019 Union of British Columbia Municipalities (UBCM) conference, resolution B128 submitted by the City of Burnaby was presented and unanimously passed. This meant the municipalities present confirmed they wanted the Ministry of Municipal Affairs and Housing to review, discuss and respond to the resolution which requested the authority for British Columbia municipalities to expand asset class diversification through prudent investor rules. The request would mean a change to the Community Charter and would allow investments in equities, mortgages and other asset classes as deemed appropriate by the municipality.

The Provinces of Alberta, Saskatchewan and Ontario have already gone through the legislative changes to provide prudent standards for municipal investments with expanded asset class choices, global investment diversification and overall risk reduction. It was recognized that long term sustainment requires broader investment parameters; after all, cities maintain reserves and other funds that should be earning greater than the rate of inflation. These funds are critical for future development and long term growth, but are prescribed to limited investment options within the Community Charter.

In February 2020, the Ministry of Municipal Affairs and Housing responded to the UBCM resolutions and specifically noted that the provincial government is not willing to make changes to the Community Charter, and that "*Under the current provisions, all local governments, regardless of size and capacity, have access to a prescribed list of allowable investments including the Municipal Finance Authority's (MFA's) pooled investment funds*".

After the Ministry's response, the City of Burnaby and the MFABC continued discussions regarding risk adjusted returns and all options available to ensure long term financial sustainability for BC municipalities. The MFABC has recently obtained a legal opinion with respect to the MFA Act and the Trustee Act confirming their ability to implement a new multi-asset class growth fund for municipalities, designed for investing long term reserve funds not required for ten years or longer. The MFABC will be meeting with Ministry officials in the fall 2020 to discuss the intentions under the noted Acts, of providing such a fund.

The work and effort put into these discussions are a culmination of many hours by City of Burnaby and MFABC staff. Working diligently and with Burnaby Councils involvement from the beginning with the UBCM submission, we have been able to find and bring about investment opportunity for many municipalities, not just Burnaby. While in other provinces a city may set their own investment guidelines and goals relative to prudent investing, with the decision by the BC Ministry, our only option is to explore a collective pooled fund through the MFABC. When it comes to SRI or ESG related guidelines for this fund, the complexity will become even greater as the MFABC designs and offers one-size-fits-all funds. The plan is to incorporate a sustainability lens for this new fund which hopefully will be available by the end of Q2-2021. The challenge is to find a "moral compass" that all municipalities agree upon; whether that is simply a fossil fuel free exclusionary growth fund or a specific set of guidelines within an ESG mandate. Though there is still much work ahead, the process is still slowly moving forward, which is a positive. Shifting up to $300 million of the City's long term reserves to the new MFABC Sustainable Growth Fund, for a ten year or longer timeframe, would allow the City to maintain a more diversified portfolio of assets with greater risk adjusted returns targeting 5% per annum. Committing funds longer term also smooths out any market volatility that can occur in the short term.

6.0 RECOMMENDATION

The growth of socially responsible investment parameters and investing based on various environmental, social and governance policies has grown substantially over the last decade. Concerns regarding climate change, labour laws and employment standards and fairness are driving change for a better and more sustainable future for all.

The current SRI and ESG market however is still rather immature with many actors utilizing different standards and varying metrics. This poses a challenge when determining if an investment decision should exclude a particular industry all together or simply specific companies.

Until such time that the ESG landscape matures with clear disclosure, standardization and cost-effective approaches, formally incorporating ESG standards beyond the prescribed investment limitations under the Community Charter will continue to be a challenge. However, the City's existing investment portfolio which does not have an official ESG specific guideline, already invests in widely accepted government and financial institution investments who prescribe to the United Nations Principles for Responsible Investing. Thus, the City is investing in guarantors that are committed to the incorporation of environmental, social and governance factors into various decision making processes and operations.

When looking at the MFABC pooled funds, which are all currently managed by PH&N who is a UN PRI signatory, the investment holdings are screened prior to purchase. And while the MFABC identifies two funds as ESG specifically guided, essentially all of the pooled funds are.

The City continues to work with the MFABC to move forward with prudent investment standards by obtaining final consultation with the Ministry of Municipal Affairs and Housing. The end goal being a multi-asset class growth fund, which would introduce equities and other types of assets to an MFABC pooled fund, designed for reserve funds not required for ten or more years. This will ensure investment based on risk adjusted returns and long term financial sustainability. Maintaining a completely prescribed portfolio of government and bank/credit union debt actually introduces multiple levels of risk that can be addressed with this new fund. Meetings with Ministry and Provincial officials are scheduled over the next several months. As additional information becomes available and develops, a report will be provided with further investment recommendations.

It is recommended that the Financial Management Committee receive this report for information.

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Copied to: City Manager