City of Port Moody
Report to Finance Committee

Date: February 14, 2020
Submitted by: Finance and Technology Department – Financial Services Division
Subject: Divesting the City's Investment Portfolio Away from Fossil Fuels Analysis

Purpose
To provide options and information on the feasibility and financial impact of divesting the City of Port Moody's (the City) investment portfolio away from financial instruments that support fossil fuel companies.

Recommended Resolution(s)

THAT the report dated February 14, 2020 from Finance and Technology Department – Financial Services Division regarding Divesting the City's Investment Portfolio Away from Fossil Fuels Analysis be received for information;

AND THAT staff be directed to amend Corporate Policy – 05-1860-01 – Investment of Available Funds to include a percentage of investments in the Municipal Finance Authority's Fossil Fuel Free Short Term Bond Fund for Council's consideration.

Executive Summary
Over the past two decades, an increasing number of investors have begun to consider non-financial criteria, such as social and environmental criteria, in making investment decisions labelled socially responsive investing (SRI). Various investors, with different motives, engage in SRI through distinct strategies. This report discusses the challenges associated with implementing a specific SRI strategy called exclusion screening (divestment). While the SRI movement is gaining momentum, the effects of SRI strategies have been difficult to identify and quantify. As a result, using engagement as an alternative approach to changing behaviour was viewed as a more effective investment strategy to change environmental, social and corporate governance (ESG) performance of public companies.

However, the 2018 local government elections saw many changes of councils throughout the province, which came with a change in views and added urgency to a variety of environmental and climate change initiatives, including fossil fuel divestment. As a result, there has been added pressure on agencies like the Municipal Finance Authority (MFA) to respond and develop specific fossil fuel free investment funds. Staff have been following these and other efforts with interest in preparing information for this report. This report will discuss challenges to all socially responsible investing strategies, as well as the impact to the City's investment portfolio.

Background

At the March 27, 2018 Regular Council meeting, a Council report (**Attachment 1**) supporting the movement by a number of public institutions, private entities, and pension funds that had taken positions to divest their investment portfolios away from companies that profit from fossil fuels was discussed. The report proposed that the City look beyond portfolio performance and adopt a policy that supports the divestment movement, helping steer the economy away from reliance on fossil fuels as a long term financial strategy to protect the global environment. Essentially, the report was proposing to align the City's investment practices with the City's environmental and social values. This position was supported by a motion of Council at the June 11, 2019 Regular Meeting whereby a climate emergency was declared.

While the March 27, 2018 report identified examples of sound environmental benefits and rationale that have garnered global support for the movement, it was silent on the challenges related to adopting a financial strategy that divests portfolios away from certain industries or commodities, many of which were identified by Council during the discussion that followed. While the concept of moving the economy away from fossil fuels had philosophical support, the strategy was considered to be too broad, complex, and sweeping to adopt without further analysis that weighed both the benefits and the challenges.

In that vein, the following motions were passed directing staff to perform an analysis on the fossil fuel composition of the City's investment portfolio, provide information on the impact and considerations for moving funds invested with the MFA into the MFA's Socially Responsible Investing (SRI) fund, as well as options for divestment of fossil fuel investments for Council's consideration.

> *RC18/150*
> THAT staff be directed to report back with an analysis of the City's investment portfolio and dealings with financial institutions, highlighting investments and dealings that are related to the fossil fuel sector.
>
> *RC18/151*
> THAT the aforementioned report include options for divesting the City's investment portfolio and severing the City's financial dealings with banks supporting the fossil fuel sector as recommended in the report dated March 1, 2018 from Councillor Rob Vagramov regarding A Call To Divestment – Aligning City Investments With The Future.
>
> *RC18/153*
> THAT the City of Port Moody inform the Municipal Finance Authority (MFA) that the City will move any future MFA investments into a fossil-free Socially Responsible Investment (SRI) fund if such a fund is established by the MFA.

As mentioned, since the 2018 motions above were passed, the 2018 election saw many changes of councils throughout the province, which came with a change in views and added urgency to a variety of environmental and climate change initiatives, including fossil fuel divestment. As a result, there has been added pressure on agencies like the MFA to respond and develop specific fossil free investment funds especially in light of the failed attempt to garner sufficient interest in their SRI fund. Council recently, at their January 28, 2020 meeting, provided similar support and encouragement for the MFA to develop a fossil fuel free fund with the following motion:

> *RC20/091*
> THAT Port Moody City Council write a letter to Municipal Finance Authority to express interest in a fossil fuel free investment product as recommended in the report dated January 17, 2020 from Councillor Amy Lubik regarding Request to the Municipal Finance Authority to Provide a New Fossil Fuel Free Investment Product.

MFA has responded to the desires of their members and is preparing to launch a Fossil Fuel Free (FFF) Short Term Bond Fund. This report will discuss challenges to all socially responsible investing strategies, as well as the impact to the City's investment portfolio.

Discussion

It is widely acknowledged that the extraction and burning of fossil fuels contributes to atmospheric buildups of carbon dioxide, and that, as a result, the earth's temperatures have been slowly increasing to critical levels causing catastrophic climate changes. As a result, there is global acceptance that industry and the economy should be moving away from reliance on fossil fuels to reduce carbon emissions into the atmosphere. Where the debate lies is in the urgency, how the transitions should be managed, and where the pressures to reduce should be exerted.

There is a widely held belief that finance can be a tool to combat climate change. Following along this line, the suggestion is for the City to exert pressure by diverting City investment funds away from companies that use those funds to finance the extraction and burning of fossil fuels. However, as we all use fossil fuels in our daily lives, both in business and personally, any adopted strategy needs careful consideration as any policy changes can have significant economic, competitive, and life-style impacts. There is also the added element of other divestment movements that may also be presented to Council in the future (e.g. tobacco, plastics), which can put limitations on the scope and breath of investment opportunities.

The other point to consider is whether the City of Port Moody should implement a SRI strategy unilaterally, or alternatively, lead or join a larger more consolidated voice to exert pressure on the senior governments to make, or speed up national or provincial policy changes.

The purpose of this report is not to discuss the pros and cons of divestment. Staff have been asked to prepare a portfolio analysis and divestment opportunities and options for Council to review and consider. Before options are presented, it may be helpful to get a full understanding of the City's investment function, as well as the principles under which the current Policy was developed.

<u>Treasury and Investment Considerations and Challenges</u>

The City's Finance and Technology Department manages the Treasury function (banking, cash, and investment portfolio), balancing operational and capital cash flow requirements against the corporate goal of maximizing returns on idle funds generated from reserves and operational revenue streams. A good investment policy provides guidance and typically balances the objectives of preservation of capital, liquidity, and return on investment. The City's investments are managed under Corporate Policy – 05-1860-01 – Investment of Available Funds (the Policy) **Attachment 2**. The policy sets a goal to:

> "*provide the optimal blend of investment security and return, while meeting the daily cash flow demands of the City and complying with the statutory requirement of the Community Charter."*

The Policy is silent with respect to socially responsible investment strategies. The following challenges and benefits to adopting a socially responsive investment policy or a fossil fuel free investment strategy are provided for discussion and consideration:

1. <u>Allowable Investments – *Community Charter*</u>

   BC municipalities are regulated by the Community Charter (the Charter). Section 183 legislates a municipality's ability to invest in certain investment funds and securities. The *Charter* restricts municipalities to the following investments:

   (a) securities of the Municipal Finance Authority;
   (b) pooled investment funds under section 16 of the *Municipal Finance Authority Act*;
   (c) securities of Canada or of a province;
   (d) securities guaranteed for principal and interest by Canada or by a province;
   (e) securities of a municipality, regional district or greater board;
   (f) investments guaranteed by a chartered bank;
   (g) deposits in a savings institution, or non-equity or membership shares of a credit union; and
   (h) other investments specifically authorized under this or another *Act*.

   Unlike municipal counterparts and other public entities in the United States (US), which can invest in more risky instruments (e.g. derivatives), the Charter limits the City's investments to fairly conservative instruments from well-established, regulated and financially backed or insured sources (generally brokered through Canadian agencies). The legislation is by design to prevent municipalities from over speculating, and putting themselves in financial distress. Therefore, the Policy strives to strike a balance between portfolio risk and portfolio performance.

   The report on the March 27, 2018 Council Meeting agenda identified a number of entities, including US cities and universities that had divested their portfolios of fossil fuel companies. However, there is one significant difference in their structure compared to BC municipalities. US cities can invest in equities (stocks/shares of publicly traded or privately held companies) whereas BC municipalities cannot (unless participating in the MFA pooled fund). This allows US counterparts to directly target those companies that extract, use, or burn fossil fuels. BC municipalities invest in large very diverse pool funds (e.g. banks, provinces), many of which are likely to be partly composed of companies targeted for divestment. Therefore, it is much more difficult if not impossible for BC municipalities to screen unwanted investments from the larger pools of this nature.

2. <u>Defining Divestment</u>
   As mentioned above, divestment can be broad, complex, and sweeping so a clearly and carefully defined scope is needed. However, this can be challenging as many of the allowable investments under the *Charte*r are provincial and federal bonds, many of which use fossil fuels to some degree as Canada is largely a resource-based economy. There also may be other products that investors (taxpayers) may want to divest, reducing the scope of allowable investments. The challenge is screening out what will be divested, and what will not. This may be a labour intensive effort, if at all feasible or manageable.

3. <u>Representing All Taxpayers Equitably</u>
   The City is a service provider to its many residents and businesses, and strives for service excellence and equal access to those services. The City also provides financial stewardship over the community's assets that are needed to deliver those services in a stable and cost efficient manner. Assets include the cash reserves, which are invested under policy to maximize returns to help achieve those service goals. Divestment is recognized as an effective a climate action strategy but needs to be looked at as the primary investment goal that provides a benefit to the community over the long term which would make the current Policy investment goal of maximizing short-term returns to the investment portfolio as the secondary goal.

   In addition, when setting policy over how taxpayer cash will be invested and taxpayer assets managed, it is important that we consider all taxpayers, some that may want to divest and forego portfolio performance, and others that are simply looking to maximize returns to contain service tax increases (the MFA faced the same issue with its SRI fund trying to reconcile this dichotomy). For example, residents and businesses that rely directly on the fossil fuel industry for their livelihood, may not want the City to spend their tax dollars supporting the fossil fuel divestment movement.

4. <u>Investing Cash Short Term</u>
   The City's Treasury has a unique challenge during periods of heavy capital activity with respect to generating a reasonable and acceptable portfolio yield (return on investment). Currently, the City needs to hold investment funds in short term investments so they are readily liquid to meet capital requirements, which presents a challenge generating a reasonable return on investments relative to some of our neighbouring municipalities. The short-term liquidity situation also did not allow the City to invest in the MFA's SRI fund as it had a minimum requirement of a three-year investment term.

5. <u>Clean Investments by Fossil Fuel Companies</u>
   The purpose of advocating for divesting away from fossil fuel companies is to motivate these, and other, companies to invest in cleaner and more environmentally friendly fuel alternatives. Fossil fuel companies have communicated that they are well aware of their finite fossil fuel reserves, and have been making significant investments in alternative fuels and energy sources to expand business opportunities. Divesting funds away from these companies could slow investments in this regard. The City's Investment Advisor informed the City that that is why the current recommended practice is to use advocacy rather than screening or exclusion to continue to motivate these industries.

6. Screening Fossil Fuel Companies in Pooled Investment Funds
   As mentioned, the City cannot legally invest in equities/shares/stocks of privately held or publicly traded companies directly. BC Municipalities can only invest in fixed income securities issued by Canada, Canadian Provinces, or Canadian Municipalities. Only within the MFA Pooled Fund Portfolios would the City have access to pooled options and corporate fixed income issuance. In addition, some provinces and even Canada itself could be seen as fossil fuel oriented due to the heavily resource-based economy of the country as a whole and some specific provinces, including BC, that invest in fossil fuels. The investments the City invests in through the banks, provinces, and federal government are pooled investment portfolios similar to mutual funds which likely have some level of fossil fuel products.

Motion *RC18/150* – Portfolio Composition

With respect to Council Motion *RC18/150*, staff met with the City's Investment Advisor, RBC Dominion Securities, who confirmed that major Canadian banks would be unable to determine the specific composition of each investment and, therefore, could not estimate an amount of that fund/bond was composed of investments in the fossil fuel industry.

As you see from the matrix below, all of the City's current investments, totalling $41,475,000 are from Canadian lending institutions who provide pooled funds:

Investment Type	**Book Value**	**Lending Institution**
Royal Bank of Canada GIC	$10,000,000	RBC Dominion Securities
National Bank GIC	$975,000	RBC Dominion Securities
G&F Financial Group GIC	$8,000,000	G&F Financial Group
Coast Capital Savings GIC	$16,500,000	Coast Capital Savings
Bank of Nova Scotia GIC	$6,000,000	Scotiabank
TOTAL	**$41,475,000**	

Note: as at December 31, 2019

Motion *RC18/151* – Alternate Investment Opportunities

The City's Investment Advisor advised the City of two options to consider for divesting the City's investment portfolio; Green Bonds as a fixed income investment option and adopting an SRI strategy of Advocacy and Engagement versus Exclusion. Included below in the next section of this report is a third option that has just recently become available through the MFA in March 2020, the FFF fund.

1) Green Bonds
   Green bonds are a fixed income investment in which an investor loans money to an entity (corporate or government) and the funds are used for a range of environmental projects. Like other bonds, investors earn interest and receive the principal amount back at maturity.

Although Green Bonds ensure no direct investment in the fossil fuel industry, these funds lack diversification and, as a result, have lower expected return on investment. Further, the term to maturity for green bonds is approximately 20 years, which conflicts with our current approach of investing short-term to ensure liquidity of funds. Green Bond options that are currently aligned with the City's investment policy include:

a) TransLink Green Bonds
   - The net proceeds of TransLink's Green Bond issuance will be used to finance existing and future capital projects that provide environmental benefits to TransLink and the region, and support the achievement of environmental and climate goals.

b) City of Vancouver Green Bonds
   - The net proceeds of the City's Green Bond issuances will be used to finance new or existing eligible capital projects across the City of Vancouver that meet Eligibility Criteria defined as capital projects that are beneficial to the environment, as determined by the City.

c) Ontario Green Bonds
   - The net proceeds will be used to fund projects with specific environmental benefits. Used as a funding tool to help Ontario finance transit and other environmentally friendly projects across the Province that exclude fossil fuel and nuclear energy projects.

2. Advocacy or Engagement versus Exclusion

Based on the issues noted above, the City's Investment Advisor advised that it may not be in the City's best interest, or feasible, to amend the City's Investment Policy to fully divest from fossil fuel related companies. Rather, the City could take an engagement approach, whereby companies are reviewed for specific negative impacts they have in society, rated by an independent agency, and investment decisions are made based on advocacy rather than exclusion. This strategy has the advantage of keeping the pressure on companies to move away from fossil fuels while giving them time to invest in alternative fuels.

As socially responsible investing has advanced, the discussion about how to apply the principles has evolved from institutional investors applying negative screens to their portfolios (often excluding or divesting away from "sin" stocks such as fossil fuel, alcohol, tobacco, and firearms companies) to a range of approaches with an increased focus on engagement with companies as a way to influence corporate behaviour. This approach recognizes that many of the so-called "sin" products are still relied upon by our economy or lifestyle but production methods and ongoing use and reliance still needs to move in a more socially responsive manner, constantly improving to address health, environment, and other concerns.

When asked in the context of the Fossil Fuel Free movement whether it was more effective to divest or engage, for example, 45% of respondents to a RBC 2018 survey said engagement is more effective (compared to 8% of respondents who prefer divestment), demonstrating that investors favour engaging in dialogue with companies instead of simply selling their shares.

To ensure the City follows a socially responsible investing approach, and as recommended by the City's Investment Advisor, staff recommend using lending institutions that practice socially responsible investing and take environment, social, and governance (known as ESG integration and engagement) into consideration for their investment strategies. Major Banks are evaluated annually by third party sources (similar to Moody's and Standard & Poor's who provide independent credit ratings) and are rated with an ESG score. Currently, all Canadian banks used by the City as lenders are rated as an Average Performer or better, with Royal Bank of Canada, and TD Bank rated as Outperformers in their field.

This approach would entail positive screening whereby investments would be considered using a prescribed ESG score. These ESG rankings are deemed to be reliable barometers of a commitment to environment, social and governance impacts. ESG data spans a range of issues, including measures of company environmental impact, labor and human rights policies, religion, and corporate governance structures. ESG scores, along with other factors, could be weighted in portfolio composition to guide City investment choices.

However, the SRI landscape is fragmented and complex where there is not good standardization of terminology and measurement making it difficult for municipalities to manage and develop investment strategies.

Motion *RC18/153* – MFABC Divestment in Fossil Fuels and Socially Responsible Pooled Investment Funds

1. MFA Socially Responsible Investment (SRI) Fund

   In 2017, the Municipal Finance Authority of BC (MFA) attempted to put together a SRI Fund as a divestment alternative for BC municipalities that would have likely excluded fossil fuel companies but halted pursuing the divesture of fossil fuel related assets in its pooled funds for several reasons:

   - a minimum commitment of $100 million in aggregate investment from interested participants was required but MFA only received $60 million commitment term (the $100 million minimum and three-year commitment was needed in order to defray up front set-up costs and maintenance costs of a new Socially Responsible Fund);
   - it was not financially feasible for most municipalities to commit to a three-year investment term;
   - MFA required a Council resolution from investing bodies acknowledging the increased risk and higher fees associated with such an investment; and
   - Lack of commitment from municipalities to participate in the development of socially responsible investment screening criteria.

   MFA did not receive the minimum commitment ($100 million) required from municipalities and regional districts to make the socially responsible pooled fund a viable option for municipalities.

2. <u>Fossil Fuel Free (FFF) Bond Fund</u>
   MFA is expected to launch its new Fossil Fuel Free (FFF) fund by March 31, 2020 (**Attachment 3**). This fund provides a credible, well-diversified active investment solution to MFA clients who choose to divest from fossil fuel investments. This fund will not require a minimum of $100 million being committed to the fund nor any lock-up period of three years as was the case in 2017. This was made viable due to many developments since 2017, including standardization of screening out processes and lower set-up and maintenance costs for the fund. The FFF fund will be managed by the Phillips, Hagar, North Investment Management (PH&N) (part of RBC Global Asset Management) and will use a third party screening service provided by Sustainalytics to "screen out" fossil fuel related companies.

   As noted above, Sustainalytics also provides Environmental, Social, and Governance (ESG) factor reviews and rankings of individual companies. Those ESG rankings will not be used in this particular fund. This fund is focusing on "screening out" companies while some other SRI funds that may use Sustainalytics, or other ESG analysis providers, could permit a fossil fuel related company to be purchased in a portfolio. For example, investments in an SRI fund could permit buying securities of a fossil fuel extraction company that is actively pivoting its business model into clean energy or has a clear business plan to exit fossil fuel extraction over time.

   Exclusion was the preferred approach for most local governments that MFA spoke with over the last several months while it was developing the fund. A broader SRI Impact approach was not favoured because local governments prefer the clear messaging impact associated with hard exclusion. The FFF Fund is designed to screen out all fossil fuel related companies "directly involved in the extraction, processing, or transportation of coal, oil or natural gas".

   PH&N, the fund manager, is investing in the upfront systems and paying for a standard fossil fuel screen with no charge back to MFA and, as a result, the FFF fund will be among the lowest cost actively managed bond funds in Canada, similar in cost to MFA's existing bond fund. As mentioned, there are no minimum requirements or minimum holding periods for this new fund given that no upfront costs need to be defrayed by MFA and no additional annual costs are incurred by MFA. In addition, similar to MFA's other liquid fixed income funds, the FFF fund is appropriate from a risk perspective for local governments. It will consist of well-diversified pool of Federal, Provincial, Municipal and corporate bonds with a credit rating of BBB or higher. Unlike direct deposits with major Canadian banks, these investments are not backed by the Canada Deposit Insurance Corporation (CDIC) (which is limited to $100,000 in any case).

   However, given today's ultra-low interest rate environment, and the lack of tools to efficiently purchase government bonds directly, the FFF fund offers a very cost-effective opportunity for professional management and diversification into a broad category of bonds otherwise not featured in many local government portfolios. For example, at least 30% of the securities in the fund must be issued by the Government of Canada or a Province. The current MFA Bond Fund, a good comparator to the credit quality of the upcoming FFF fund, has about 50% of investments in AAA securities (better credit risk than any Canadian bank, which are AA- rated at best) and the rest invested in AA, A and BBB securities, with about 18%

currently invested in BBB securities (BBB is widely considered to represent Credit Union risk in Canada).

The FFF fund, while offering daily liquidity, is most appropriate for reserve moneys not needed for 2.5 years or longer due to the interest rate sensitivity of its fixed investments. Unlike a daily deposit account at a bank, which remains constant as interest rates move up or down on a daily basis, the value of fixed bonds go up and down every day based on interest rate movements, which is where the risk lies should the City need to liquidate before the 2.5 years when the bond interest rates had dropped. The interest rate risk associated with the FFF fund is limited as MFA does not allow investments in very long dated bonds (say 10-, 20- or 30-year fixed bonds). It may invest only in fixed rate bonds of up to 7.25 years in maturity and will typically target about three years in duration.

Given this recommended longer holding period (2.5 years), and the fact that the City has significant capital and other short-term cash flow needs, the fund would only be appropriate for a portion of the City's investments. The City has been keeping its existing investments short term purposefully to meet these short-term cash flow needs.

Other Option(s)

THAT staff be directed to provide additional information on divesting the City's investment portfolio away from financial instruments that support fossil fuel companies.

Financial Implications

As discussed above.

Communications and Civic Engagement Initiatives

There are no communications or civic engagement initiatives associated with this report.

Council Strategic Plan Objectives

Proper management of investing the City's available funds supports the strategic plan objective of Service Excellence. In addition, Council has a Strategic Priority of Environmental Leadership that has an Objective that states "Expand and enhance policies to guide environmental goals and sustainability programs". Amending the Corporate Policy – 05-1860-01 – Investment of Available Funds to include a portion of investments that divest City funds away from fossil fuels meets this Objective.

Attachment(s)

1. March 27, 2018 Regular Council Agenda Report – A Call to Divestment – Aligning City Investments With The Future.
2. Corporate Policy – 05-1860-01 – Investment of Available Funds.
3. Municipal Finance Authority of BC Fossil Fuel Free (FFF) Short Term Bond Fund.

Report Author

Paul Rockwood
General Manager of Finance and Technology

Report Approval Details

Document Title:	Divesting the City's Investment Portfolio Away from Fossil Fuels Analysis.docx
Attachments:	- Attachment 1 - March 27 2018 Regular Council Agenda Report - A Call to Divestment - Aligning City Investments With The Future.pdf - Attachment 2 - Corporate Policy 05-1860-01 Investment of Available Funds.pdf - Attachment 3 - Municipal Finance Authority of BC Fossil Fuel Free (FFF) Short Term Bond Fund.pdf
Final Approval Date:	Mar 11, 2020

This report and all of its attachments were approved and signed as outlined below:

Dorothy Shermer, Corporate Officer - Mar 10, 2020 - 11:31 AM

Rosemary Lodge, Manager of Communications and Engagement - Mar 11, 2020 - 12:19 PM

Paul Rockwood, General Manager of Finance and Technology - Mar 11, 2020 - 4:19 PM

Tim Savoie, City Manager - Mar 11, 2020 - 5:13 PM