Responsible Investment Advisory Group

Meeting of 14th September 2022
Item 4 – Paper B
Management of Climate Related Financial Risk

Background

1. Since the last RIAG meeting on 13 July, DLUHC has launched a policy consultation that includes detailed provision of the requirements that will be placed on LGPS funds. A summary of key points is at Annex A. That consultation concludes on 24 November.

2. The draft consultation does not include a set of draft regulations for scrutiny but the Department does anticipate having these made by March 2023.

Key Questions for Discussion

3. The Group is asked to give its initial views on some of these key questions:
   - Should the response to the consultation focus on the specific proposals and compliance with those, or should we consider further actions to tackle climate change?
   - What level of consistency does the Group want to see in target setting and the scenario analysis?
   - How do we go about designing templates for funds to report to SAB, and do these need to be consistent with data coming into the funds from their investment managers? How consistent is that data at present?
   - How can we ensure funds are prepared for and have access to the necessary extra expertise needed to fulfil these new obligations?

Climate action and the LGPS

4. The TCFD regime, which is largely replicated in this consultation proposal, is essentially a reporting and monitoring framework. The reporting of metrics and indeed any targets set are not binding and do not directly influence the pension committee's decision-making powers on investment. The consultation states, "the urgency of climate change means that the trustees cannot wait until it has 'perfect' data before it starts putting it to use." The "use" to which this data is likely to be put, however, is clearly to drive more sustainable investment behaviour. While pension committees can and do take ESG factors into account, they may only do so consistently with their fiduciary duty.
   The Group is asked to consider whether in its consultation response, the Scheme Advisory Board should recommend that the government consider moving beyond this package of reporting measures and mandate more tangible actions.

5. That could potentially include asking funds to produce "transition plans[1]". It might also include providing guidance as to what changes in investment behaviour are most appropriate for funds. For example, are reductions in carbon emissions due simply to changes in asset allocation less "worthy" than those derived from reductions in carbon emissions associated with the same assets held over a period of time (either through engagement or technological change)?

6. Given that LGPS assets totalled c£340bn at 31 March 2021, and with the widespread use of passive investment vehicles, there is also a question about whether it is meaningful to differentiate the performance of the fund in reducing carbon from the success of carbon reduction in the world economy generally. This would again suggest that decisions around the targeted and strategic deployment of capital into climate adaptation are likely to be more effective than any target setting or reporting activity.

Consistency of metrics and targets

7. The consultation proposes that funds set a target from a range of different mandatory metrics. There are potentially advantages, in terms of effectively communicating scheme-level action and the potential for economies of scale, if all LGPS funds were required to report against the same metrics.
   Does the Group feel in its response the SAB should propose that DLUHC set common metrics for funds? If so, what should those metrics be? Does the same logic also apply to targets?

Reporting templates

8. The Department has suggested that SAB should lead on the development of a template to be used by funds to feed into the scheme-level report, and that the use of SAB's template could be mandatory. The advantages of a mandatory template include that it would facilitate a means to accumulate the figures from the individual funds, and the SAB will be able to ensure that the design is methodologically rigorous. The Secretariat expect this Group to lead on that, with input and sign-off from the other committees (IGE and full SAB).
   Do the Committee agree that would be acceptable and, if so, how do committee members want to feed into the drafting of that template? Would a smaller working group be helpful?

[1] A climate transition plan is generally understood to be a time-bound action plan that clearly outlines how an organization will pivot its existing assets, operations, and entire business model towards a trajectory that aligns with the latest and most ambitious climate science recommendations. i.e., halving greenhouse gas (GHG) emissions by 2030 and reaching net-zero by 2050 at the latest, thereby limiting global warming to 1.5°C

9. A further question is where the data to populate these templates is coming from and will come from. If it is important to keep a clear look-through to source data from companies, it might mean ensuring that there is some consistency between the SAB template and any reporting templates used by fund or investment managers. The alternative would be to rely on summaries and analysis from intermediaries in compiling the scheme-level report. **Do Group members believe that it would be necessary or advantageous for there to be a complete look-through to the source data?**

10. An initial steer is sought from the Group as to how detailed the SAB template should attempt to be. At one end, there is PLSA's Carbon Emission Template – which is very detailed – and at the other, DLUHC's suggestion of just one number for each of the (minimum) four metrics used by each fund. The DLUHC suggestion would make the compilation of a single, scheme-level total relatively simple, but might lack the detail necessary to properly interpret the data. For example, by understanding where the methodologies in the estimation of missing data were inconsistent in the returns from different LGPS funds.

Resourcing and Expertise

11. As with any new function or responsibility, funds will want to consider what additional level of resources they may need to fulfil the requirement. That is likely to be both in terms of extra volume of work and the need to bring in additional expertise in certain areas. The Group is asked to give their views on the likely level of extra resource needed to produce a compliant report. **Do the costs look like more those in the DWP IA (£15k) or USS experience ("six figures")?**

12. In order to inform our consultation response we propose to run a survey, using the questions at Annex B. **Do Group members approve this survey, and if so, do they have any comments on the proposed wording of those questions?**

13. There is also a question of whether it would make sense for funds to jointly commission expert scientific input into what trajectories for emission reductions are credible for a scheme the size of the LGPS, and the specific transition scenarios it is reasonable to use. This could be done at fund level, through pools or alternatively through collective procurement (such as the frameworks administered by Norfolk County Council). If that were to be the Group's preference then the Secretariat will explore how that could be done and when, in terms of timetable, that activity would need to start. **Do Group members support a collective approach to procurement?**

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Annex A

Key Points from DLUHC Consultation Paper

1. Each administering authority (AA) will need to publish an annual Climate Risk Report
2. The first report will cover the financial year 2023/24 and must be published by December 2024, either as a stand-alone document or as part of the AA's annual report.
3. Scheme members must be informed that the Climate Risk Report is available in an appropriate way.
4. AAs will be expected to identify climate-related risks and opportunities and assess their impact on their funding and investment strategies.
5. AAs will be expected to establish and maintain a climate specific risk management process and integrate this into their overall approach to risk
6. AAs will be required to review their investment strategy against two scenarios. One scenario must be Paris-aligned and one scenario will be of their choice
7. AAs will be expected to set targets and report annually against the metrics below:
    - Absolute emissions metric Scope 1, 2 and 3 greenhouse gas (GHG) emissions
    - Emissions intensity metric
    - Data Quality
    - Paris Alignment Metric. In particular, the percentage of their assets for which there is a public net zero commitment by 2050 or sooner
8. The Scheme Advisory Board (SAB) must prepare an annual Scheme Climate Report including a link to each individual AA's Climate Risk Report (or a note that none has been published) and aggregate figures for the four mandatory metrics. We also propose that a list of the targets which have been adopted by AAs
9. AAs need to ensure they have access to proper advice when making decisions relating to climate-related risks and opportunities

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Annex B

Proposed Survey Questions

1. As of now, does your fund have the necessary resources in place to produce a compliant report by December 2024?
2. If not, do you have an approved project plan that will enable you to deliver a compliant report by December 2024?
3. Do you believe that you have access to the data that you need in order to populate a climate risk report?
4. How would you assess the quality of that data?
5. Do you have a plan in place to improve the quality of the data you hold to an acceptable standard?
6. Are you planning to do analysis yourself, based on raw data provided by investment managers, or will you rely on someone else's analysis?
7. Would you like to be able to look-through to source data?
8. Have you already made an assessment of what expertise you need to do projections, scenarios, analyse data?
9. If so, do you have those resources or a plan to get those resources?
10. If not, when do you intend to carry out that assessment
11. How do you anticipate that this reporting will change your fund's approach to asset allocation approach or choice of investments/funds?