Responsible Investment Advisory Group

Meeting of 13th July 2022
Item 4 – Paper B
Management of Climate Related Financial Risk

Background

1. At the RIAG meeting on 18 May the Group was given a presentation by DLUHC on its emerging thinking on implementation of climate change reporting for LGPS. Previous meetings have received papers outlining the content of the TCFD Regulations which apply to private sector pension schemes. For ease of reference a summary of what the TCFD Regulations require of private sector schemes is at Annex A.

2. The only action from the May RIAG meeting was to ask DLUHC to come back once its thinking was more developed. Up until the recent changes in the composition of the Government, we had expected to have a much clearer statement from DLUHC about the policy content of the consultation for this meeting. The forward timetable will now need to be set by new ministers and there is little more that officials are likely to be able to say on that. However, for funds there are still important questions on climate risk reporting that this Group can helpfully address. It is also the Secretariat's view that the change in government ministers is unlikely to result in significant changes to approach to climate change risk reporting, for private or public sector schemes.

3. The SAB's view when it met on 6 June was that we should try to get more onto the front foot and start thinking through what our position should be when the consultation is finally issued.

Progress with TCFD reporting in other schemes

4. The DWP Consultation in October 2021 said that "An increasing number of UK occupational pension schemes are recognising these risks through the voluntary adoption of Net Zero targets: approximately 85% of defined contribution (DC) pension savers are now in a scheme with a Net Zero target. More than 10 of the UK's largest defined benefit (DB) pension schemes have also set Net Zero targets, including the two largest - Universities Superannuation Scheme (USS) and the BT Pension Scheme."

   We expect that the USS will be publishing its first report at some point this month and when that is issued we will circulate it around the Group for information.

Climate related targets in the LGPS

5. There is already a plethora of climate change targets across the LGPS and local government more broadly. We know that different administering authorities are likely to take different views on what a suitable target should be; which may be influenced by the local authority's general approach to net zero but could also be quite different from the local authority's, given the very different nature of the targets.

6. Funds and their pools also don't necessarily share the same target dates to achieve carbon net zero portfolios. Some have declared "climate emergencies", some have already set ambitious net zero targets (2030) and others have chosen to follow the UK government's target of being net zero by 2050. The extent to which targets by funds are properly informed by scientific evidence regarding climate change and carbon emission reduction requirement are likely to vary. In addition, funds will have different levels of expertise and resource to understand and develop appropriate target setting.

7. The differences in local targets may lead to presentational difficulties and create confusion amongst national and international level stakeholders about the commitment of the scheme as a whole to tackling climate change. However, it needs to be recognised that there is no ready consensus with regards to a single target.

Scope 3 emissions

8. Scope 1 and 2 emissions are those that are attributable to the actions of a company in carrying out its business and include the emissions associated with its inputs (including energy), whereas Scope 3 emissions are those not under the control of the company and include "downstream" costs of that company's activities. Excluding Scope 3 emissions greatly reduces the validity of targets set. E.g. a company which mines coal for a power station will have similar Scope 1 and 2 costs to a company that mines lithium for electric car batteries – and it is only the Scope 3 emissions which distinguish them. Decisions made with the aim solely of reducing Scope 1 and 2 emissions could have perverse effects and indeed reallocate investment towards fossil fuels.

9. Private sector schemes were not required to report on Scope 3 emissions in year 1. There is an argument that LGPS funds should catch-up and report on Scope 3 emissions from the start. However, there is as yet no settled methodology for accounting for Scope 3 emissions, and it is recognised that there is a problem of double counting. If a fund invests in a product manufacturing company and a manufacturer which is involved in that

company's supply chain then their Scope 3 emissions could include some downstream emissions being counted twice.

10. One way around this problem which is being developed is to use "de-duplication multipliers." If you have a big enough dataset (i.e., a universe encompassing thousands of companies), it is possible to estimate the amount of would-be duplicated emissions across a portfolio and adjust for it. When applied, the multiplier results in a figure closer to the actual carbon footprint.

11. Given the relative differences in reliability of reporting of emissions of different scopes, does the Group agree that they should be reported separately, and that further work should be done to provide guidance to funds on consistent reporting of Scope 3 emissions?

Measuring data quality

12. DLUHC spoke at the last meeting about a data quality metric being mandated for funds. DWP suggest that for private sector schemes, a data quality metric would look at "the proportions of the portfolio for which the trustees have high quality data. Trustees should calculate the proportion of the portfolio for which each of Scope 1-2 emissions (and from the second scheme year onwards Scope 3) emissions are verified, reported, estimated or unavailable. For the portion of the portfolio in the "estimated" category, trustees may also calculate the proportions estimated to different degrees of certainty."

13. There are emerging methodologies for carbon emissions reporting, for example The Global GHG Accounting and Reporting Standard for the Financial Industry (carbonaccountingfinancials.com).Examples of what the reporting tools for data quality look like are in Annex B.

    Does this Group have views on how robust these data quality metrics are and whether it would support a requirement to report against them?

The role of pools

14. As with TCFD reporting in private sector schemes, the reliability and comparability of the data is determined by the quality of what is received from investment managers. Even without national level standards, there is still potentially a role for pools in leveraging good practice and a wider range of suitable financial products from investment managers. Pools could insist on standardising data collection and reporting by the managers it works with, playing a similar role as in the case of signing up to the Transparency Code.

Pools would potentially have the market weight to set required methodologies, assumptions and reporting templates for investment managers to follow.

Are members of the Group aware of other initiatives (e.g. by FCA or TPR) to standardise data collection or reporting?

15. The TCFD regulations require consideration of "at least two scenarios where there is an increase in the global average temperature and in one of those scenarios the global average temperature increase selected by the trustees must be within the range of 1.5 degrees Celsius above pre-industrial levels to and including 2 degrees Celsius above pre-industrial levels".

16. The pools could also set a standard set of scenarios for managers to use. The kinds of scenarios which have been proposed include "orderly transition", "abrupt, late transition" and "inadequate transition". Tools, endorsed by DWP, are already being developed to support the application of these scenarios. See for example PACTA / Climate Scenario Analysis Program - 2DII (2degrees-investing.org).

    Does the Group agree that the Secretariat should approach pools to discuss how they can help bring greater standardisation to reporting and use of scenarios?

Reporting templates

17. An online method of reporting which follows a standardised methodology would be much more useful from the perspective of being able to compare funds and compile date for the entire scheme. Individual fund level reporting has the potential to result in reports which cannot be compared and result in a lot of individual duplicated effort at the fund level.

18. Once private sector schemes start producing their reports it may be possible for the Secretariat to review these and devise a template suitable for LGPS. Without that, the inevitable divergence of fund targets, methodologies, assumptions will make it much harder for the Board to bring those together to compile a scheme-level report. It will also make it much harder to funds to benchmark their own progress and make meaningful comparisons with peers.

    Are there any volunteers from the Group who would be willing to review a selection of reports over the summer and feed their views into the Secretariat to support recommendations at the next RIAG for a template for LGPS?

    Does the Group have recommendations for other bodies or individuals who might also be willing to contribute their expertise to such a review?

Governance

19. In fulfilling their new duties on climate change risk reporting, funds are likely to need to seek further advice and support from those with relevant expertise. That might be developed internally, come from external advisers or be delegated to pool officers. In addition, non-specialist officers may need extra training to understand when to commission and how to understand this specialist advice, and then take appropriate action in order to address the climate change risks identified.

20. Does the Group believe that there is a role for SAB in supporting and co-ordinating between officers in briefing and putting recommendations to their committees on TCFD?

21. Does that include a need to provide some specific training on climate related risks, either for officers or elected members? If so, does the Group have suggestions about who would have the expertise to deliver that training?

Communications

22. There is little doubt that the introduction of reporting of climate risk in LGPS will raise still further the interest and scrutiny of its impact on climate change. While the initial reports with data are unlikely to be available until at least the end of 2024, the Scheme can expect to receive many queries from media, members and other stakeholders before then – for example in relation to target setting and what it intends to report on.

    Does the Group have any views on how the climate change reports can be positively communicated to scheme members and other stakeholders? There is an inherent difficulty in communicating the complexity and uncertainty around what the data means and how it has been compiled. How do we manage to tell a compelling narrative with these reports?

    What is the role of different groups represented at the Group, eg employers and trade unions, in communicating what the scheme or their fund is doing?

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Annex A

Quick Summary of what TCFD Regulations require

The high-level summary is that pension funds need to:

- undertake scenario analysis;
- obtain Scope 1, 2 and 3 greenhouse gas emissions and other data relevant to your metrics;
- use that data to calculate your metrics. These should measure performance against one absolute emissions metric, one emissions intensity metric and one additional climate change metric;
- use these metrics to identify and assess climate-related risks and opportunities;
- measure the performance of your scheme against the target you set.

These metrics are reported on by schemes "as far as they are able". The regulations define this as taking "all such steps as are reasonable and proportionate in the particular circumstances taking into account… the costs, or likely costs, which will be incurred by the scheme… and… the time required to be spent by the trustees or people to whom the trustees have delegated responsibility".

DWP have set out the following principles for effective disclosures

1. Disclosures should present relevant information specific to the potential impact of climate-related risks and opportunities on the scheme avoiding generic or boilerplate disclosures that do not add value to members' understanding of issues.
2. Disclosures should be specific and sufficiently complete to provide a thorough overview of the scheme's exposure to potential climate-related impacts and the trustees' governance, strategy and processes for managing climate-related risks and opportunities.
3. Disclosures should be clear and understandable showing an appropriate balance between qualitative and quantitative information.
4. Disclosures should be consistent over time to enable scheme members to understand the development and/or evolution of the impact of climate-related issues on the scheme.

5. Disclosures should ideally be comparable with other pension funds of a similar size and type.
6. Disclosures should be reliable, verifiable and objective.
7. Disclosures should be provided on a timely basis. The TCFD recommends annual disclosures for organisations.

There is further elaboration in the statutory guidance.

Annex B

Examples of data reporting templates

Listed Equity and Corporate Bonds

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Table 5-3. General description of the data quality score table for listed equity and corporate bonds[61]

(score 1 = highest data quality; score 5 = lowest data quality)

Data Quality	Options to estimate the financed emissions		When to use each option
Score 1	**Option 1: Reported emissions**	**1a**	Outstanding amount in the company and EVIC are known. **Verified emissions** of the company are available.
Score 2		**1b**	Outstanding amount in the company and EVIC are known. **Unverified emissions** calculated by the company are available.
	Option 2: Physical activity-based emissions	**2a**[62]	Outstanding amount in the company and EVIC are known. Reported company emissions are not known. Emissions are calculated using primary physical activity data of the **company's energy consumption** and emission factors[63] specific to that primary data. Relevant process emissions are added.
Score 3		**2b**	Outstanding amount in the company and EVIC are known. Reported company emissions are not known. Emissions are calculated using primary physical activity data of the **company's production** and emission factors specific to that primary data.
Score 4	**Option 3: Economic activity-based emissions**	**3a**	Outstanding amount in the company, EVIC, and the **company's revenue**[64] are known. Emission factors for the sector per unit of revenue are known (e.g., tCO_2e per euro of revenue earned in a sector).
Score 5		**3b**	Outstanding amount in the company is known. Emission factors for the sector per unit of asset (e.g., tCO_2e per euro of asset in a sector) are known.
		3c	Outstanding amount in the company is known. Emission factors for the sector per unit of revenue (e.g., tCO_2e per euro of revenue earned in a sector) and **asset turnover ratios** for the sector are known.

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Commercial Real Estate (CRE)

Table 5-9. General description of the data quality score table for CRE

(score 1 = highest data quality; score 5 = lowest data quality)

Data Quality	Options to estimate the financed emissions		When to use each option
Score 1	**Option 1: Actual building emissions**	**1a**	Primary data on **actual building energy consumption** (i.e., metered data) is available. Emissions are calculated using actual building energy consumption and **supplier-specific emission factors**[129] specific to the respective energy source.
Score 2		**1b**	Primary data on **actual building energy consumption** (i.e., metered data) is available. Emissions are calculated using actual building energy consumption and **average emission factors** specific to the respective energy source.
Score 3	**Option 2: Estimated building emissions based on floor area**	**2a**	**Estimated building energy consumption per floor area based on official building energy labels AND the floor area** are available. Emissions are calculated using estimated building energy consumption and **average emission factors** specific to the respective energy source.
Score 4		**2b**	**Estimated building energy consumption per floor area based on building type and location-specific statistical data AND the floor area** are available. Emissions are calculated using estimated building energy consumption and **average emission factors** specific to the respective energy source.
Score 5	**Option 3: Estimated building emissions based on number of buildings**	**3**	**Estimated building energy consumption per building based on building type and location-specific statistical data AND the number of buildings** are available. Emissions are calculated using estimated building energy consumption and **average emission factors** specific to the respective energy source.