Consultation response: Governance and reporting of climate change risks

Hymans Robertson LLP provides independent pensions, investments, benefits and risk consulting services, as well as data and technology solutions, to LGPS stakeholders, employers, trustees and financial services institutions. We are committed to helping our clients manage their investments more successfully by treating climate risks as an integral part of our research, advice and services and to create positive change by raising awareness of the implications of climate risk on financial planning.

We are supportive of this consultation and the proposal to embed climate risk governance and reporting requirements into the LGPS, aligning the public sector with those already in place for private sector pension schemes. As long-term investors, the LGPS can play an important role in addressing climate change through its investments and stewardship. We have provided a more detailed response to each question raised but the key points of our response are as follows:

- The proposals will deliver a broad framework for climate risk governance and reporting. Whilst the detail of the requirements will be delivered through statutory guidance, we believe a consultation on any such guidance is necessary to ensure best practice. We also believe that specific guidance for Pools may be helpful. We would be delighted to provide further detail as part of such a consultation but have set out in the body of our response areas for further consideration.
- Mandating the adoption of certain metrics will enable comparisons to be drawn across the LGPS. However we are concerned that scheme-wide reporting will result in league tables being drawn up and comparisons being made without appropriate context. Whilst we concede that this is an inevitable outcome of this, we would encourage such reporting to be proactive in addressing these issues, highlighting areas of best practice across the LGPS. We also believe that guidance should ensure that definitions are clear to avoid misleading comparisons being made.
- Whist the proposals create a statutory minimum for the LGPS, we believe that the proposals should encourage greater ambition given the long-term nature of LGPS liabilities. We are supportive of the approach suggested through the proposals and encourage government to ensure that the guidance emphasises the consideration of climate risks and opportunities through multiple lenses.
- Stewardship is only given limited consideration as a tool within the proposals whilst we see this as a key mechanism through which asset owners can exercise influence. This is of particular importance to the LGPS as long-term asset owners with higher equity allocations and the ability to engage collectively. We would encourage government to emphasise the role that stewardship can play within guidance.
- The proposals suggest a need to set and report on targets but are silent on the need to take action to achieve such targets. We believe this is a notable gap in the proposals and, whilst supporting the fact that such targets are not legally binding, believe it appropriate that administering authorities ("AAs") consider and report on the actions that they intend to take. This reinforces the role of stewardship.
- Finally, we believe the proposals and guidance should not be overly prescriptive that innovation is stifled. There are a multitude of approaches to understanding, managing and reporting on climate related risks and these should be acknowledged as these proposals are introduced. Given the complex nature of climate risks, maintaining diversity of views and methodologies and allowing these to be debated and learned from has the potential to deliver the best outcome for the LGPS.

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Proposed requirements

To achieve the goals of the Paris Agreement and the government's green financing plan, it will be necessary for the entities responsible for carbon emissions to put in place and implement plans for significant emissions reduction over coming years. Whilst asset owners may focus inwardly on the risk that climate change poses to their own pension scheme and take action to integrate climate risk management policies, asset owners must also take responsibility for the impact that their assets have on the world and hold laggards to account for their inaction.

Asset owners have two tools to create impact: capital allocation and the exercise of stewardship. However, in order for these tools to be exercised effectively, it is necessary for asset owners to not just focus on the current position of a company, portfolio or strategy, but also on the mechanisms for change that may already be in place. Climate change must be considered through multiple lenses, recognising that multiple approaches to tackling climate risk will be valid, but that the goal should be real world change. Whilst consistency in the reporting and definition of metrics will allow comparisons to be made, ensuring that one approach is not inappropriately penalised in comparison to another has to be a feature of these proposals given the likely scrutiny that will arise.

We note that the requirements set out by the proposals create a broad framework for Funds to follow and comply with. We expect that any guidance which will sit alongside the requirements on Funds will have a lot more detail and, as a result, be important for Funds to refer to. As such, we believe a consultation on any such guidance will be crucial and in doing so we expect to provide further detail and opinions on what Funds will be expected to undertake and produce.

The proposals make limited reference to the exercise of stewardship as both a risk management and impact tool. However we see active ownership as a key mechanism that can be employed by the LGPS, particularly in light of continuing higher allocations to equity assets. We would expect the exercise of voting and engagement by Funds and Pools, particularly through collaborative action, to increase over time in order that laggards are held to account. Increasing the focus on stewardship either within the proposals or through guidance would therefore be sensible.

Whilst the proposals make reference to expected statutory guidance for AAs, we believe that it may also be helpful to have additional guidance, statutory or otherwise, for Pools. Given the importance that such guidance will play, we hope that government will consult separately on this guidance prior to the proposals being finalised.

Question 1: Do you agree with our proposed requirements in relation to governance?

We believe the proposed requirements are broadly sensible, however have a few comments per below.

We assume that where the proposals refer to scheme managers that this means the AAs of each Fund. If not, further clarification of the role of scheme managers should be included for clarity.

The proposals refer to expertise being provided by the committee's officers, advisers and the Pool – we believe that it may be helpful for guidance to outline examples of what advice each of the officers and the Pool may be expected to provide. It could also be helpful to clarify whether there are further resources within the Pool that can provide support and where these may be best directed.

We agree that it is sensible for legal duties to not be placed on individuals, whilst still requiring them to ensure that Funds comply with the rules by instead placing duties on AAs.

Question 2: Do you agree with our proposed requirements in relation to strategy?

We agree with the proposed requirements.

We believe it appropriate that guidance include comment on appropriate time horizons. Whilst there will be some differences between individual Funds based on local membership, it remains the case that Funds are open to the future accrual of benefit and hence have long time horizons. An outcome where there was significant difference in what was considered “long term” would be inappropriate.

Question 3: Do you agree with our suggested requirements in relation to scenario analysis?

We agree with the proposed requirements on scenario analysis.

Given the broader goal of creating comparators (or potentially aggregations) across the LGPS, we believe the supporting guidance should contain greater detail on the scenarios to be considered to ensure that there is a broadly consistent interpretation of future climate pathways.

Our experience of undertaking climate scenario analysis for private sector schemes and the visibility of scenario analysis across the industry, has demonstrated material differences in approach and output between schemes. We do not believe this is inappropriate. Indeed, we believe a plurality of approaches is to be welcomed as it offers scope for innovation, the evolution of different methodologies that may better integrate climate risk and tailoring to the circumstances of individual Funds.

Climate scenario modelling is in its relative infancy and we would encourage government not to be overly prescriptive, particularly with regard to methodology within statutory guidance as this runs the risk of developing group think.

Question 4: Do you agree with our proposed requirements in relation to risk management?

We agree with the proposed requirements on risk management, noting that the proposed approach again creates a framework for the consideration of risks which will be supplemented by statutory guidance.

We note that the third proposed requirement, ‘*Ensure, on an ongoing basis, climate-related risk management processes are integrated into their overall risk management’* rightly suggests the need for regular review by AAs. This is appropriate given the understanding of climate risk and risk management processes will necessarily evolve. This equally places an obligation on government to ensure that the statutory guidance is regularly reviewed to ensure it remains consistent with prevailing best practice. We would expect such review to take place at least triennially to match valuation cycles, although more regular reviews may be appropriate during the early years of implementation.

Question 5: Do you agree with our proposed requirements in relation to metrics?

Overall, we are broadly supportive of the proposed requirements, although would make the following comments.

The categorisation of data as set out by the proposals is sensible, with a focus on quality rather than availability. However, in our experience, metrics currently available to asset owners do not typically make a distinction between verified and reported data. This may lead do some difficulties in compiling this metric in the early years of implementation, albeit that the process of requesting more information on data serves to improve the underlying data collection. Government may wish to clarify that such a distinction falls under the banner of ‘as far as Funds are able’ as are other expected data issues.

Guidance needs to address the extent to which AAs should be expected to estimate missing or unavailable data and the benefits that this may convey. As noted, we recognise there is merit in asking for and collecting data and this creates a demand for underlying measurement and the associated behavioural change. Unless there is a clear rationale for estimating data, then we think it more appropriate to report gaps rather than spending time and money on estimations.

Paragraph 70 suggests that the total of Scopes 1, 2 and 3 emissions should be reported. We would question what purpose this would serve as approaches that reduce Scope 1 and 2 emissions are different to those by which Scope 3 emissions may be reduced. Further, whilst we note that some organisations report this total, we would question whether this is appropriate given the potential double counting.

We support the use of a binary target as the portfolio alignment metric where the actions that can be taken to improve performance against the metrics are clear. Further, this avoids potential complications in understanding the complex methodologies and assumptions used as well as potential communication difficulties that are posed by the other portfolio alignment metric approaches. However, we believe that regulations and/or guidance needs to be clearer on the definition of what comprises an appropriate target as the proposal is somewhat ambiguous in this regard. The declaration of a net zero or Paris-aligned target means little unless backed up by a credible plan. We therefore propose that this metric reference Science Based Targets or an equivalent verification.

We further note that the other approaches described prove useful as part of a broader approach or in the future when they are better understood and more consistent across the industry. We particularly expect that the use of benchmark divergence models will increase as more Funds consider net zero pathways where sector specific analysis is critical and for, upon improvements in methodology, Implied Temperature Rise to form part of communications due to the output being easily understood by members. We therefore support the encouragement for AAs to make use of additional metrics.

The proposals focus on aggregable types of data where possible, and we note that this is helpful in comparing and contrasting underlying asset mandates and enabling decision making. However, in doing so, there is a possible unintended consequence that across Pools, and therefore the LGPS, heavy reliance may be on a limited number or even singular data providers. This may result in increased risks, and so we would advise that guidance clarifies how best to avoid this whilst also retaining the positive elements of aggregation and comparability, where required. We would also impress the need for appropriate levels of independent verification of data wherever possible to ensure what is reported is clear, reliable and thus not potentially misconstrued.

We also note that availability of climate related data is likely to improve over time. It may therefore be worth clarifying that where gaps exist in the early years of disclosure, metrics can be developed over time as further data becomes available. This also applies to methods of cleansing data, which are still in earlier stages of development. As metrics evolve, so different methodologies and definitions may emerge which could lead to inconsistencies in reporting. We therefore recommend that, as far as possible, guidance precisely defines how particular metrics should be set.

As noted, our preference is for guidance to encourage asset owners to develop a core understanding of the different types of metrics available, their uses and limitations and select metrics that are appropriate to their own strategy and governance approach. This was our approach for private sector schemes. Whilst the proposed approach has its benefits in mandating certain metrics, ensuring a focus on the development of these metrics, we support the proposal that Funds also consider additional metrics. This may be helpful in informing their understanding of risk exposures and decision making and guidance should emphasis the benefits of considering a broad suite of climate related metrics.

Question 6: Do you agree with our proposed requirements in relation to targets?

We agree with the proposed requirements although believe these could be strengthened slightly.

Whilst we believe it sensible that targets should be framed with reference to one of the selected metrics and that they shouldn't be legally binding, one purpose in setting a target is to frame the actions that are being taken to try and achieve it.

We propose that guidance makes clear that the most useful and appropriate targets are those where AAs are able to clearly influence outcomes against the target, rather than targets that could be expected to be achieved regardless of any action taken by the authority. Further, we believe it would be helpful if guidance supported the use of multiple targets, thereby ensuring that the actions being taken to address climate risk are broad based in nature.

Building on this, one area where the reporting requirement could be strengthened, either through regulation or guidance, would be to require TCFD reports to set out the actions that have been taken by AAs to try and achieve their targets. This would create a clear link within the TCFD framework between the understanding and management of risks and opportunities to the actions taken as a consequence and the resultant outcomes.

Question 7: Do you agree with our approach to reporting?

We broadly agree the proposed approach to reporting as set out.

The proposals suggest a single reporting approach which targets multiple audiences, making suggestions as to how this could be accommodated. Given the complex nature of climate risk and particularly the technical nature of many of the governance and reporting requirements, we believe it preferable to be clearer in the proposals, for example, with the short member-oriented summary being the preferred means of communicating to the lay reader. Adopting a standard form of this summary whilst allowing greater flexibility in how more technical details are communicated may support transparency across the LGPS.

We also believe that the following should be included as requirements within the reporting:

- Future steps to be taken in rectifying gaps in activity and/or reporting, for example, as part of the 'metrics not calculated' section.
- Within targets, what actions that have been taken by the AA to achieve the targets set.

It is unclear within the proposals who has final responsibility for climate risk reporting within the AA, although we assume this is the scheme manager (primarily the Pensions Committee). Clarification on this would be welcome.

Question 8: Do you agree with our proposals on the Scheme Climate Risk Report?

We believe that aggregated data would be the most appropriate way of reporting across the LGPS. Although we do not believe it appropriate to include the data on individual AAs, we see this as an inevitable consequence of this reporting. If it is not done centrally then other bodies will undertake this exercise and publish the information, creating "league tables".

The use of such league tables without the context of the strategies adopted by individual Funds could be counterproductive, creating a risk of challenge to individual AAs, with resource being drawn into responding to more detailed requests for information. For instance, a Fund that adopts a more measured strategy to reducing carbon emissions may be making a greater contribution to real world change than a Fund whose focus is on reducing carbon emissions as quickly as possible, whereas both strategies are valid.

One potential consequence of this reporting is that Funds may be challenged to act now (reducing carbon emissions through divesting from high emitting sectors) rather than working with companies to encourage decarbonisation of processes and economic activity. The SAB should ensure that this risk is appropriately managed.

We, slightly reluctantly, conclude that the reporting of individual Fund data should be a feature of the Scheme wide reporting. Such reporting should then focus on ensuring that the necessary context is provided, identifying areas of positive practice and offering case studies that others can aspire to. Where data is reported, there should be clear explanations of the differences that can arise and the reporting should endeavour to explain the ranges in outcomes that will inevitably arise between Funds. Further, reporting should ensure there is an appropriate focus on actions that are delivering real world emissions reductions.

Consideration may be given to whether reporting is separated between different asset classes, thus allowing more appropriate comparisons.

Finally, the proposed aggregation of data requires that there is consistency in the definitions adopted for reporting purposes. As we note above, aggregation of the Paris alignment metric may be misleading unless there is a clearly objective basis for measurement. Differences in the basis for measurement, particularly if more draconian bases are adopted, could draw unwarranted scrutiny.

Question 9: Do you have any comments on the role of the LGPS asset pools in delivering the requirements?

We believe that Pools should support and drive stewardship by making available relevant strategies, rather than dictating them. By referring to Pools as potential drivers of strategy, this perhaps suggests that Pools may prescribe transition timelines and relevant strategies, leading to inconsistency with the approach that different Funds wish to follow. Therefore, we believe that the language used in the section could be made clearer and less open to interpretation.

When considering the role of Pools and whether aligning strategy and targets is appropriate across Pools, we would urge caution in suggesting this, as it may encourage a 'lowest common denominator' approach. Clarity on what could be reasonably expected would be useful, therefore, in ensuring that approaches taken are appropriately ambitious.

Question 10: Do you agree with our proposed approach to guidance?

We agree that statutory guidance should be provided and have noted, in our comments, areas which we believe should be addressed within this guidance.

Climate reporting is at an early stage of its evolution and to suggest that there is a single reporting approach that would capture that broad range of potential practices at this time is concerning. This could stifle innovation and mean that the focus of reporting is drawn away from the approach taken by an individual Fund. For example, a Fund that uses capital allocation as its primary tool may have a different emphasis in its reporting to a Fund that uses stewardship as its primary tool.

Similar to the approach that has been adopted for UK Stewardship Code reporting, we suggest that SAB provide more detailed principles/guidance on reporting content (and perhaps offer a template that could be used), but without being overly prescriptive or mandating a singular reporting approach. This would allow the emergence of best practice over several years at which time greater levels of prescription may be sensible.

As noted above, we believe that more detailed guidance on the format of "member friendly" reporting would be of benefit.

Question 11: Do you agree with our proposed approach to knowledge, skills and advice?

We agree that decision-making individuals need to have appropriate knowledge and understanding of the topic and therefore proper, high-quality advice must be received.

We are concerned by the suggestion that Pools could jointly procure advice for their partner Funds. Joint procurement resulting in a singular appointment may result in a lack of diversity of thinking and an inappropriate level of challenge. As we have noted, this may stifle innovation and restrict the way that approaches may evolve over time in lieu of expectations of efficiency.

There are various means by which the approach to considering climate advice could be tested. For example, AAs could use an industry standard framework such as that developed by the Investment Consultants Sustainability Working Group as a basis for making an assessment. AAs could also be asked to report on how they have ensured the advice is of high quality within their governance processes.

Question 12: Do you have any comments on the impact of our proposals on protected groups and on how any negative impacts may be mitigated?

We are not aware of any elements of the proposals that could impact protected groups.

We would like to draw attention to the area of climate justice and the goal of ensuring a just transition, which means finding solutions that not only reduce emissions and improve the world with respect to climate issues, but that do so in a way that works towards a fairer and more equal world. Given this, in preparing statutory guidance, government should consider the extent to which both actions and reporting should align with the broader goal of a just transition.