Local Government Pension Scheme England and Wales

Scheme Advisory Board (SAB)

Department for Levelling Up, Housing and Communities

Local Government Pension Scheme (England and Wales): Governance and reporting of climate change risks

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Response to consultation

This response is submitted on behalf of the Local Government Pension Scheme Advisory Board (England and Wales) which is a body set up under Section 7 of the Public Service Pensions Act 2013 and The Local Government Pension Scheme Regulations 110-113.

The Board's purpose is to:

- Provide advice to the Secretary of State and to administering authorities on "the desirability of changes to the scheme" and "in relation to the effective and efficient administration and management" of the LGPS
- Provide a framework to encourage best practice, increase transparency and coordinate technical and standards issues across the sector

Membership of the Board includes equal number of voting members representing employers and employees. The Board is also supported by non-voting members and advisors.

There are around 18,000 employers participating in the Scheme and therefore there are representatives of some of the larger employer groups (further/higher education institutions and academy schools) on the Board and its sub-committees.

Secretariat services are provided by the Local Government Association and separate Advisory Boards have been established for the LGPS in Scotland and in Northern Ireland.

This response was compiled by the Board Secretariat in consultation with members of the Board's Responsible Investment Advisory Group.

Yours sincerely,

Cllr Roger Phillips
Chair of the Board

Scheme Advisory Board (SAB)

Response to consultation questions

Preliminary remarks

Before moving onto the consultation questions the Board would like to make some general observations on this important policy area.

Timing of Consultation

The Board is fully in sympathy with the need to catch up with the requirements in the private sector and some funds have already been voluntarily producing reports in line with the Taskforce on Climate-Related Financial Disclosures (TCFD) requirements. In many ways it is a shame that the LGPS requirements are behind DWP's climate risk reporting regulatory framework, as it could give the impression that LGPS funds are less engaged in making sustainable investment choices, which is far from the case. For example, the Environment Agency's Fund is seen as particularly advanced in this area.

Given that there has been this lag, the Board would like to see the Government publish a summary of the learning from the first round of TCFD reporting in the private sector. That should include any work done by DWP with TPR on compliance issues in relation to those schemes that they regulate.

Role of Pension Funds

The Board recognises that as the largest funded defined benefit scheme in the UK, and one of largest sources of global capital, the Local Government Pension Scheme has an important role to play in the transition to a net zero economy. It believes that stakeholders across the Scheme will endeavour to play their role to the fullest extent and with enthusiasm.

However, its role as an institutional investor is constrained in comparison with the impact which national government policy can have. While pension funds can and should declare their climate strategy and impact, there is a need for government policy to be fully aligned on these questions. Pension funds would find it much easier to make better environmental investment choices if the regulatory and tax policy incentives were also aligned with them.

In line with the "polluter pays" principle, the Board believes that the Government should consider the broad range of its powers to put in place an effective tax and investment incentive regime. That should have the aim of ensuring that organisations that are causing emissions are responsible and pay for the full environmental cost of their actions. Related to that, we would like to see further development of policies which allow negative externalities to be better incorporated into decision making such as a carbon pricing system, which would do much to reduce the tension between pension funds' primary obligation (to seek returns) and their strong desire to improve environmental performance.

The Board feels that in a sense it is putting the cart before the horse with these proposals by nudging funds towards making changes in their investment decisions, before those other policy levers have been deployed to support those decisions. However, the Board fully supports the development of a regulatory regime for the LGPS around climate risk reporting.

The fiduciary duty and investment choices

To develop that a little further, the Board notes that as with DWP's climate risk reporting regime, which is largely replicated in this consultation proposal, the proposals essentially

institute a reporting and monitoring framework. The reporting of metrics and indeed any targets set are not binding and do not of themselves drive the decisions of a pension committee on investment. The consultation states, “the urgency of climate change means that administering authorities cannot wait until they have ‘perfect’ data before they start putting it to use.” The “use” to which this data is put is clearly to drive more sustainable investment choices and to improve transparency.

We therefore believe that this policy is intended to be a “nudge” for pension funds. In order to be fully effective, the Government should be clear about this, align policy levers (as stated before) and clarify whether its intention is that these proposals should help to reshape the contours of the fiduciary duty. We note that the Advisory Group on Finance (AGF) that was formed by the Climate Change Committee stated in its report on the road to Net Zero in finance that, “To be successful, it will be crucial to ensure that these and other regulatory measures drive changes in fundamental behaviour rather than simply narrow compliance.”

The Board agrees that climate change risk (whether physical or technological) will in many cases be financially material and so, in terms of the Law Commission’s analysis, should be taken into account by all funds where relevant. However, there will be occasions where this materiality is not so clear and funds will want to make choices which do not necessarily maximise returns but do support important climate goals. It is recognised that LGPS funds are free to do this where it does not cause “significant financial detriment”, and where they can justifiably believe that scheme members would support that approach.

However, where we feel the fiduciary duty might require some further clarification on is the extent to which the pursuit of carbon or temperature reduction targets may justify investment choices that entail some element of financial detriment – compared to the counter factual – and how that should be determined. If the intention is not that targets should exert some influence on investment choices, then their value would be greatly reduced.

Also, Government guidance would help clarify the application of the Law Commission’s advice in an LGPS context, where the primary fiduciary duty is owed to scheme members, but duties are also owed to scheme employers and local tax-payers.

Also, it should be accepted that in a scheme that contains six million members there will be a multiplicity of views on climate change and investment choices. Funds should already have processes in place for engagement with a broad range of stakeholders in the development of their Investment Strategy Statements. They will therefore be familiar with the need to balance diverse perspectives, be they from employers, scheme member representatives or pension committee members themselves.

The Board notes that polling generally supports the view that the general public, and especially younger people (who are those joining the scheme now and who are most likely to be affected by investment choices taken in the future), very much support environmental considerations being taken into account. However, guidance could helpfully clarify what best practice should be for funds wishing to gauge member or local tax-payer support for prioritising achievement of their particular climate targets.

The appropriate means to achieve the ends

The Board would also like to work with officials to develop best practice guidance on what changes in investment behaviour are most appropriate for funds. For example, there is

generally a view that reductions in carbon emissions due simply to changes in asset allocation are less appropriate as a tool for meeting targets 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). This latter approach itself delivers a reduction in carbon emissions while the former potentially simply reallocates them within the market. Guidance could also help funds decide to what extent they want to strategically deploy capital into climate adaptation technologies that are likely to unlock the path to a net zero economy more widely. These might be investments which stretch a fund's appetite for risk but again might enjoy the support of members and bring significant returns over time.

Given that LGPS assets totalled c£340bn at 31 March 2021, and with the widespread use of pooled or passive investment vehicles, there is also a question about whether it is realistic to try to differentiate the performance of the scheme in reducing carbon from the success of carbon reduction in the economy generally. Again, we come back to the point that national governments, ideally acting internationally, are the only bodies that can really help deliver net zero targets for large pension funds like the LGPS.

Resourcing production of climate risk reports

As with any new function or responsibility, funds will want to consider what additional level of resources they may need to fulfil the requirements. 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 Board believes that creating these reports will be very resource-intensive and will also require more training for committee members and officers.

DLUHC have stated that they were expecting the estimated cost of compliance to be similar to that which DWP has estimated for private sector schemes in its Impact Assessment for their equivalent Regulations . Based upon anecdotal experience of private sector schemes having already produced reports for year 1 of the DWP requirements, the Board feels that DWP's figure is likely to be an underestimate, and it would likely be many times that amount for an LGPS fund. We expect that costs will come both from the procurement of external expertise (although funds should try to maximise the amount of work that can be done by their investment managers and others down the supply chain) and expanding current teams. The Board will look to facilitate joint working and procurement where possible, eg via pools or the National Framework, not least because many funds are already experiencing difficulties in recruiting and retaining adequately resourced teams.

Responses to specific questions

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

Yes, but as mentioned earlier, the Board would like the Government to draft guidance to clarify how these responsibilities are intended to relate to the over-arching fiduciary duty.

The consultation refers to the need for funds to have advisers who are "properly qualified". The Board believes that instead funds should be required to "take proper advice". We prefer this wording as there is currently no particular qualification or certification that is appropriate, and funds are familiar with the "proper advice" formulation. That said, the Board believes

that it would be appropriate to have further clarification of what constitutes “proper advice” in this context provided in guidance, rather than on the face of the regulations. The statutory guidance to the Investment Regulations 2016 does refer quite generally to “proper advice”, but that is in relation to functions (selection of investments and investment managers) which funds have always undertaken and are well understood. This is a new function and so greater clarity on the expectation would be welcome.

The Board also believes that statutory guidance should spell out the expectation on local pension board members. We expect to engage with the Department on the way to formalise the knowledge and skills requirements of pension committee members as part of its response to our Good Governance recommendations.

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

The Board felt that the language in the consultation document in this section was more around ongoing risk assessment than what it would understand as strategy. Indeed, the summary of this section and that on risk management are strikingly similar. It also needs to be clear that the strategy is what pulls together and brings clarity of purpose to the separate duties that are proposed (around governance, risk assessment, metrics etc) rather than being a separate element of its own. It is important that each of the component parts work together and pull in the same direction.

For the Board, strategy suggests an over-arching approach that endures over time and directs action in a range of circumstances. This is the sort of thing that might also be described as a transition plan. We understand that term to mean a time-bound action plan that clearly outlines how an organisation will pivot its existing assets, operations, and entire business model towards a trajectory that aligns with the latest and most ambitious climate science recommendations. The Board notes that at COP26 the Government had said that transition plans would be mandated at some point.

Doing so will also allow funds to offer greater assurance that their targets are genuine and deliverable. There is also a question about whether climate campaigners will infer from the setting of a target that a plan to deliver it is legally required. There has been litigation already in the courts whereby failure to take action to achieve clean air targets has been ruled unlawful. This would be a concern for LGPS funds of course, but the Board believes that it is possible to mitigate the risk.

The Board feels that calculating and disclosing carbon emissions associated with assets will not by itself “encourage better pricing and capital allocation in markets”. The Board believes that LGPS funds need to recognise, in setting their strategies, that they are active participants in the market. Opportunities lie in quickly identifying the significant negative externalities that are built into their existing holdings and acting to address them. Passively waiting for these externalities to be appraised is itself a major risk, both in relation to those holdings and future value in the market as a whole (as implied temperature rises are strongly inversely related to GDP growth).

The Board would also like to suggest that guidance on strategy or transition plans needs to take into account both the need for them to be very long-term (including commitments to action throughout the life-times of those members just joining the scheme) while at the same time recognising the urgency of taking significant steps towards net zero in the coming 7-8 years.

Related to this is the question above about the need for best practice advice on the approach which funds should take. That would cover the respective roles of divestment, engagement and strategic allocation of capital to key technologies which could unlock transition.

One key issue which is lacking in the consideration of strategy is time period. Some schemes define long term as 40 years. While this may appear long term for most of the scheme, for the purposes of climate change risk and given that it is irreversible it remains very short term. The profit will be extracted and the damage will be cause in the next decades and the consequences will be felt in the decades after. The government recognises that funds have a primary duty to their members to act in their best financial interests. Yet, assuming the possibility that an 18 year-old member of the LGPS reaches the age and is paid a pension as the oldest person alive today, incorporating climate change ought to require funds to consider a time period of up to 100 years into the future. A consultation on risk ought to require funds to investigate what investment decisions are required today to prevent total climate destabilisation during the lifetime of members of the LGPS to enable the LGPS to continue to pay their pensions. Indeed, the fact that funds do not currently undertake such analysis demonstrates a very real and currently existing legal risk that they will be challenged for investment behaviour in carbon intensive industry contrary to the best interests of their members not therefore in adherence with their fiduciary duty.

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

The Board agrees that, while challenging, consideration of different scenarios is valuable in terms of bringing these reports to life. In terms of communicating with members, scenarios can have a valuable educational role as well.

Two or more scenarios do seem appropriate and we would suggest that scenarios other than the Paris-aligned one should be required to illustrate the effect of global temperature rises above 2° (since that now seems likely). In addition, we believe that these scenarios should not be limited but that funds should choose from a small, defined set of scenarios to ensure comparability between funds. There is also a need to consider whether this set should include those scenarios that the FCA require investment managers to run already (and therefore should already have tools and expertise to run for LGPS funds). The Board believes that a small set of plausible scenarios should be agreed and included in the statutory guidance, together with a presumption that pools should provide this expertise (see later comments on the roles of pools).

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

The Board supports the proposals in this section and looks forward to seeing draft statutory guidance on how it is to be delivered. The Board believes that the key output of risk

management is a programme of mitigations and believes that these should also be recorded and reported as part of the fund's climate risk report.

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

The Board would preface its remarks on this section by noting that LGPS investments are extensive and diverse. LGPS funds invest in over 50 jurisdictions all around the world. Each of these jurisdictions has different standards and obligations of corporate reporting and transparency. In some cases, there will be no legal obligation on bodies in receipt of investment from LGPS funds to provide or even record this information. Accordingly, funds will need to make the provision of this data a condition of business which might affect both the reliability of the data received and the diversity of bodies that they are able to invest in.

The Board has considered whether the Department should try to impose greater consistency in the metrics on which data is to be compiled. However, on balance and at this point in time, it leans more towards retaining flexibility in target setting, use of metrics and scenario analysis. This should be reviewed as best practice solidifies; it is important to emphasise that flexibility is key, as this is an ever-evolving area.

The Board also agrees with the approach set out in the consultation, namely that at this early stage the regulations should be high-level with the specifics in statutory guidance.

The Board approves of the choice of the absolute emissions metric and the obligation to report separately each of scopes 1-3. In terms of the proposal in paragraph 71 for the Department to set a single methodology for attributing carbon emissions to investments, we would urge caution. It may be wise, at this stage, to allow for a range of methodologies to be used and for an evaluation of these to be done once they have been properly tested. Only at that point would the Board support moving to a single methodology, which has the merit of allowing for full comparability. However, we do not believe that there has yet emerged a single methodology which could be deemed to be the most appropriate.

The Board is also hopeful that the FCA, FRC and Accounting Standards Board will fulfil their roles in achieving accurate data reporting. Until there are agreed industry standards, it will be difficult to aggregate data from different sources.

The Board would also like to clarify the divergence between paragraph 90 and 134. Paragraph 90 talks about a "top-level figure" for each Scope of emissions being required, while paragraph 134 suggests that funds will report proportions that are verified, reported, unavailable or unknown. The Board understands better, and would prefer, the latter approach.

The Board agrees that there is no need for reporting to be done investment by investment. However, we would also suggest that funds report against these metrics separately by asset class and not just for the fund as a whole.

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

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."

The Board is aware that many LGPS funds have not yet set a net zero ambition. Those that have set out their ambition have chosen quite different dates. Although the Board recognises the weaknesses of net zero target dates (and would argue that they are not meaningful without associated interim targets and transition plans), we believe that they are the common currency of public discourse and if LGPS funds didn't give an indication of their goal of when to achieve net zero by, the public would find that hard to justify.

The Board acknowledges the compelling conclusion reached by the Committee on Climate Change advisory group on finance who have called for a net zero target to be the default for the UK financial system.[1] In their 2020 report they state, "It is critical that net-zero becomes the default option for savings and pensions, with more sustainability linked products providing financial incentives for decarbonisation." They add, "Managing climate risks to financial assets is clearly necessary to deliver net-zero, but it is far from sufficient. Capital also needs to move at scale towards activities and assets that are enabling households, firms and public authorities to make net-zero a reality."

The consultation frames funds as being subject to climate change, rather than as contributing to climate change through the companies they are invested in. Although ESG considerations are incorporated into the policies of most funds, many remain risk averse, believing that because the primary purpose of the fund is to pay pensions any decisions that may lead to an impact on returns cannot be justified. The Board would emphasise again that there is a need for the Department to clarify that the fiduciary duty does permit such decisions to be made, and that they are in fact necessary in order to make tangible progress towards net zero targets.

Regarding paragraph 112, the Board understands that having a net zero target would not require a fund to divest from or invest in a particular investment, but it is hard to see how portfolios can be aligned with the targets set without some changes being made in investment choices.

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

The Board believes that there is a case for having different reporting timescales for different asset classes. While it is possible for funds to report reasonably credible data on equities (particularly listed equities) in their first climate risk report, data for other asset classes is not reliable and in some cases entirely missing. The Board believes that for reports to have some credibility, and for the analysis in them to be meaningful, reporting requirements for different asset classes should come on board as they become credible. This would not prevent funds reporting sooner than required where that is possible but acknowledges the reality of the current position and allows some time for the relevant asset managers to improve the availability and credibility of their data.

[1] Finance-Advisory-Group-Report-The-Road-to-Net-Zero-Finance.pdf (theccc.org.uk)

As well as publicising the existence of reports to scheme members, we would like to see Regulation 61 (Statements of policy concerning communications with members and Scheme employers) amended to include specific reference to the administering authorities setting out a policy approach to communicating climate risk. Related to that, we believe that where any scheme employer has a substantial proportion of its staff eligible to join LGPS then funds should encourage them to put a link to that climate risk report on their website as well.

The Board notes that the consultation (at paragraph 6) suggests that there will be a further consultation on reporting standards at a later date. The Board would urge that this consultation includes proposed common definitions, categories and reporting standards to be adopted. Given that funds have little option but to rely on currently unverified reported data from further down the investment pipeline in compiling these reports, we would wish to put on record at this stage the Board's view that any auditing of these reports should be explicitly limited to whether it has been professionally assembled and not whether assurances can be given about the accuracy of all data reported.

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

The Board are happy to take responsibility for the production of a scheme level report, which would include links to each of the fund reports. The Board does however note that initially their report is likely to be limited to a commentary on the work undertaken at fund level. There are data quality and consistency issues that may need to be resolved before conclusions can accurately be drawn about performance at the scheme level. Otherwise, the Board risks giving spurious credence to aggregated, and possibly largely estimated, data, which would undermine its own credibility. The Board believes that these data quality and consistency problems are very real and could take several years to resolve. As mentioned earlier, given that LGPS funds invest in so many jurisdictions we are likely to need international standards in place before reporting will be meaningful.

To do otherwise risks placing more weight on largely synthetic data than it can bear. The Board feels that its report could still add real value by commenting on the different approaches which funds have adopted and drawing attention to best practice and year on year improvements – especially around data quality.

In addition, what is proposed is an annual reporting obligation. That means that there is very little that can be reliably inferred from the data until there are sufficient data points to create some trend lines, which would show how effective different approaches have been in meeting the targets funds have set for themselves.

The Board again notes the reference in paragraph 137 to divestment as a means of reducing emissions. While divestment can be seen as a failure of engagement, the Board feels that selective disinvestment from particular companies it is a necessary tool in a fund's armoury if it wants to engage seriously with companies and effectively change their behaviour. There are also likely to be some companies who are not willing to engage with funds in reducing their carbon footprint and are quite prepared to lose LGPS business as a consequence.

In terms of pulling data in from funds to create a Scheme Climate Risk Report, the Board has already set up a working group that will look at the information that it is necessary to have. From that we will establish templates that can offer as frictionless a flow as possible

from funds' own sources of data (through investment managers and pools, down to funds). This is important to minimise the burden on all parties and avoid data being lost or misinterpreted as it passes through the chain.

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

As with climate risk reporting in private sector schemes, the reliability and comparability of the data is determined by the quality of what is received from investment managers. While the determination of the content of the Responsible Investment policy remains with funds, there is clearly a role for pools to leverage good practice from investment managers.

The Board believes that there should be an operational "pool first" presumption, i.e. that data would be collected and analysed by the pool unless there was good reason not to, which would help to standardise data collection and reporting. That could potentially be extended to cover all fund assets, and not just those held in or via the pool.

Pools would potentially have the market weight to set required methodologies, assumptions and reporting templates for investment managers to follow. Adoption of standardised templates for reporting has worked well in relation to the Board's Code of Transparency around investment costs, and it is possible that climate risk reporting could follow a similar path, but with pools leading discussions with those investment managers who were unwilling to provide climate-related data in a prescribed form.

As mentioned earlier, the proposals suggest 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 AAs must be within the range of 1.5 degrees Celsius above pre-industrial levels to and including 2 degrees Celsius above pre-industrial levels". The pools could 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". These could be based on existing tools, such as those endorsed by DWP, that are already being developed to support the application of these scenarios.

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

As mentioned earlier, the Board believes that the balance between what is in the regulations and what is in guidance seems appropriate and sensible. It is essential in an evolving area like climate science and reporting that flexibility is available to adapt and adopt whichever methods gain the most traction and have the most impact. This would naturally mean less prescriptive requirements in regulations, supported by statutory guidance that is easier to amend.

However, we would ask that the Department is clearer on who is responsible for producing which part of the guidance and that there are realistic timelines to provide this. The Board would also appreciate a statement on what the expectations of funds are should that guidance not be available from when the duties come into force. The Board is happy to work with the Department on what such a statement could helpfully say. The Board would also welcome a commitment from the Department for this guidance to be reviewed at defined points in the future, and then regularly, as practice in this space is fast evolving.

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There is a reference in paragraph 145 to the Board having been asked to produce "detailed operational guidance". For the record, the Board is happy in principle to do this once the policy has been consulted on and settled, but as far as we are aware we have not yet been asked to draft guidance on any specific element of these proposals.

It should also be noted that the Board secretariat will need to be resourced and funded sufficiently to undertake the significant additional tasks that the climate risk reporting framework for the LGPS will bring with it. This will mean an increase to the levy paid by funds towards the Board's costs, which comes out of the pension fund monies.

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

The Board feels that more work is needed to explore further what expert insights are available to shape LGPS reports. This should be done collectively, involving the Board.

The Board also feels that given LGPS' scale, there is an opportunity here to partner with some of the UK's universities and leading climate scientists to do some work that is market-leading and truly excellent. Such a collaboration could potentially generate valuable expertise and products that the rest of the investment sector would want to use.

Also motivating this suggestion is the Board's concern that the market for expert climate advice is variable in quality, and immature. The Board is waiting to see what standards emerge, but until government or industry regulators have settled that, there is a real risk that procurement by individual funds would lead to low value for money outcomes.

The consultation recognises that existing investment consultants and advisers working with LGPS funds will need to be able to demonstrate additional expertise. Again, the development of industry standards is critical to ensuring that the risks and opportunities presented by climate change are understood and effectively responded to.

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?

The Board believes that it is important that LGPS funds' transition plans recognise the need to support a just transition. The Board feels that this should be a strand in the best practice advice that was referred to earlier. While having regard to protected characteristics in law would only apply within the UK, the Board feels that it is important that LGPS investment policies support development goals related to equality and human rights considerations globally, as well as domestically.