Scottish LGPS Scheme Advisory Working Group **15 December 2021**

Responsible Investing – Climate Related Financial Disclosures

Working Group Members

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Background

The Taskforce for Climate Related Financial Disclosures (**TCFD**) was established in 2015 by the G20's Financial Stability Board (**FSB**). The FSB recognised the threat to financial market stability from climate change, and under the chairmanship of Mark Carney, the Governor of the Bank of England, used its mandate to reform international financial regulation and supervision by forming the TCFD.

The TCFD was established to improve climate-related financial disclosures to enhance investment, credit and insurance underwriting decisions and understanding of the concentrations in carbon-related assets in the financial sector and the financial system's exposures to climate-related risks.

It made its first disclosure recommendations in 2017 and these are structured around four pillars that represent core elements of how organisations operate: Governance; Strategy; Risk Management; and Metrics and Targets.

TCFD recommends that all organisations with public equity and debt implement its recommendations. It also recommends implementation by asset managers and asset owners, such as pension funds, as this will help beneficiaries better understand the performance of their assets, consider the risk of their investments, and make more informed decisions.

Regulation

TCFD reporting was initially introduced as a voluntary code, and some Scottish LGPS funds have been voluntarily reporting for the last 3-4 years, but in November 2020, the UK became the first country in the world to announce that all publicly listed UK companies with a premium listing would be required to 'comply or explain' with the TCFD's requirements by 2023, with mandatory TCFD-aligned disclosure expected across all non-financial and financial sectors of the UK economy by 2025.

Significantly for UK asset owners, the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 introduced mandatory reporting on a phased basis from October 2022 for occupational pension schemes (not LGPS). This followed a Department of Work and Pensions (**DWP**) consultation, including extensive engagement with occupational schemes, as well as England & Wales LGPS pools and funds and Scottish LGPS funds. The DWP guidance document accompanying the regulations was issued in June 2021 and is available here.

DWP Guidance Summary

The DWP guidance report, stretching to 50 pages, is essential reading for any public body looking to implement a similar approach. Sone of the key points are summarised as follows:

- The new requirements seek to improve both the quality of governance and the level of action of trustees in identifying, assessing and managing climate risk
- Trustees of schemes in scope must implement climate change governance measures and produce a TCFD report containing associated disclosures and publish it on a publicly available website
- Trustees are required to carry out certain activities "as far as they are able" in recognition of the cost and difficulty of obtaining some data, so TCFD reporting should be proportionate, but trustees must justify where reporting and/or data has been unobtainable under this clause
- Trustees must undertake forward looking scenario analysis showing the potential impact of climate change on schemes' assets and liabilities
- Trustees must report on a minimum of one absolute emissions metric, one emissions intensity metric and one additional climate change metric. Reporting should ('as far as they are able') include Scope 3 emissions in the second year of reporting onwards (Scope 3 includes downstream use of product)
- For the additional climate change metric, the DWP guidance suggests a portfolio alignment metric (often given as an implied temperature rating, or ITR), climate value at risk (Climate VaR) or a data quality measure, although trustees may select an alternative with an explanation of why
- Trustees must set at least one target for the scheme in relation to at least one of the metrics and measured annually
- Data estimates are permitted (and often essential) but trustees must explain why actual data is not used. Within the data quality measure, trustees should calculate the proportion of the portfolio for which each of Scope 1-2 (and from the second scheme year onwards, Scope 3) emissions are verified, reported, estimated or unavailable

Regulatory Evolution

The DWP guidance is broad and detailed, but it implicitly concedes that this type of reporting is in its infancy and there will be continuing progress in best practice, data availability, and metric methodology. By virtue of reporting being mandatory, the UK pensions industry is at the leading (bleeding?) edge in this area and there are concerns that trustees will be trapped by unsuitable historic legislation. The DWP has recognised this and allows trustees to use judgement to substitute any of the mandatory reporting segments with more suitable metrics and methodology.

The TCFD has recently (October 2021) issued its own updated guidance on metrics, targets and transition plans, highlight the shifting landscape and evolving best practice. This update to guidance was open to consultation for a short period in mid-2021, and the TCFD actively engaged with occupational pension schemes, England &Wales LGPS pools and funds, and Scottish LGPS funds. The final report is available here. The guidance provides a useful summary of recent market and industry developments with convergence of global standards and improving comparability of climate-related metrics, targets and transition plans. It also recommends more decision-useful metrics than the

backwards-looking data of simple carbon footprints. The following suite of metrics are potentially more helpful to market participants assessing and pricing risks and opportunities:

- Greenhouse gas emissions (including carbon footprint and/or carbon intensity)
- Transition risks
- Physical risks
- Climate-related opportunities
- Capital deployment
- Internal carbon pricing
- Remuneration

Not all metrics will be suitable or required for all organisations, but this expansion in recommendations demonstrates the expansion in scope and detail the TCFD wishes to see. Alongside these metrics, TCFD recommend the setting of specific targets referencing the above listed metrics (where appropriate).

To help this new target-setting process, the TCFD requested that the Portfolio Alignment Team (PAT) develop a report outlining its views on portfolio alignment metrics. Its technical report is available here. The PAT is an investment manager and consultant led group and was formed by the UN Special Envoy for Climate and Finance, Mark Carney, to promote adoption of consistent, robust and decision-useful approaches.

The report acknowledges that it is neither a product of the TCFD nor a definitive guide to the optimal technical approach to portfolio alignment tool design “given limited time, analytical capacity and provider/financial organisation engagement available to the PAT…but it should be viewed as a first step…and portfolio alignment approaches” will continue to evolve. These caveats are important because this is not a settled area in the evolution of climate-related reporting. There is significant debate, amongst asset owners, and also amongst asset managers, about how (or if) portfolio alignment metrics (specifically ITR) should be applied to pension schemes, particularly defined benefit schemes. Doubtless, as this area of study matures, these differences will be resolved. Meantime, the DWP is currently consulting on a proposal to require disclosure of a portfolio alignment metric (link).

Reporting Impact

TCFD guidance is a useful tool to better understand the climate-related risks and opportunities facing Scottish LGPS funds. Climate change is a pressing issue both in the political realm and within Scottish communities, and the TCFD offers internationally recognised best practice for reporting.

Completing a TCFD report is a non-trivial task. For those funds that are well resourced, TCFD reporting will represent a significant impact on resources, particularly during the first year of reporting. For those funds that are less well resourced (and some that are), TCFD reporting will be outsourced to consultants.

The data required to complete the reporting is an incremental cost for pension funds and it can be very expensive, regardless of whether it is sourced directly for “in-house” reporting, or whether used by consultants.

The DWP guidance is clear on the proportional use of time and financial resource, but it is worth noting that many pension funds in the occupational and LGPS sectors have complained recently of

reporting overburden, with significant increases in staff, data, and consultant costs. However, there is a strong appetite amongst trustees, officers and other stakeholders for reporting in this area.

Scottish Minister Advice

The Scottish Ministers have requested that the SAB makes a recommendation on making the TCFD reporting a regulatory requirement for Local Government Pension Scheme funds in Scotland.

The working group has been tasked with supporting that advice and reporting back to the SAB in February 2022.

It is clear that this is a fast-evolving area and that the UK is at the forefront of climate-related financial reporting. The England & Wales Scheme Advisory Board is due to launch a consultation on mandatory TCFD reporting shortly. It seems likely that the LGPS in England & Wales will follow DWP guidance as closely as possible. After all, the TCFD is seeking international consistency, and this is the leading standard currently.

The working group should, therefore, consider the DWP guidance for private sector pension funds as it is well understood by industry experts, asset managers and consultants and many public sector funds.