November 2022

Consultation response

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

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Consultation on regulations

Cardano Risk Management Limited ("Cardano" or "we") response to a consultation on "Local Government Pension Scheme (England and Wales): Governance and reporting of climate change risks" as published by the Department for Levelling Up, Housing and Communities ("DLUHC") in September 2022

Climate is a systemic risk and it is therefore crucial that all elements of the economy are incorporating and addressing climate risks; as such, we welcome the regulations, which are necessarily ambitious.

As we said in response to the consultation on *"Taking action on climate risk: improving governance and reporting by occupational pension schemes",* implementing the UK's appropriately far-reaching net zero policy will be difficult and expensive. This is precisely why clear and definitive legislation is required.

The proposed regulation provides the detail necessary for LGPS to begin reporting on climate risks. Nevertheless, we see the regulation and guidance as a starting point, and we encourage the DLUCH to continue to work with administering authorities (AAs) and their scheme managers in the months and years ahead to support the industry in meeting the UK's climate objectives.

In our response to the TCFD consultation for private schemes, we recommended a framework that:

- Pools resources to produce commonly accepted views (both on climate change scenarios and the likely impact on broad asset classes)
- Provides clear guidance on acceptable parameters that can be used in climate risk assessments

We re-state these recommendations here, in the context of our experience that trustees of private schemes have embraced the spirit of DWP's TCFD regulations. We also reiterate the importance of assessing the climate risks affecting funding strategies, and not just investment, given the long-term nature of the LGPS, which will result in more exposure to the extensive timeframes over which catastrophic climate events are expected to occur.

Understanding funding strategy exposure is therefore potentially even more important for LGPS than for private schemes. As such, analysing scenarios where private entities may be less able to support ongoing funding and using this to develop contingency and early engagement plans is likely to enhance the security of members benefits.

Finally, we highlight that it is our view that the LGPS is well placed to be a leader; and many AAs have already undertaken steps to incorporate climate change and sustainability into their decision making. In turn, other pension schemes and industries will benefit from the LGPS leadership.

We set out further recommendations in the text that follows.

Response submitted on 23 November 2022.

Question 1 & 2: Governance and strategy

A recurring theme of our submission will be that the quality of any pension fund's disclosure is determined by the quality of the underlying data, which in part will be drive by corporates' response to the new disclosure requirements for large private companies and LLPs.

In our experience, Scheme Managers are wholly committed to increased climate integration and reporting requirements. However, for most Scheme Managers, responding to the climate crisis requires a new set of skills and they are often constrained by capacity, expertise and data. As such, we recommend that:

- The DLUHC continue to work with the industry to improve the guidance available for Scheme Managers to meet their climate-related objectives, while ensuring it remains up-to-date and incorporates ongoing feedback;
- Clearer guidance is provided on the appropriate time frames for the short, medium and long term, given the unique nature and long-term exposure of LGPS to climate risk;
- Given the issues around capacity, expertise and data can often be remedied through external advisors, schemes should be encouraged to take appropriate advice where internal capability is not sufficient to meet regulatory requirements; and
- For those schemes who rely on private entities for ongoing contributions, DLUHC should provide guidance regarding the process of assessing the climate risk to funding strategies that should mirror that given to occupational pension schemes – in other words, it should be explicit that understanding the exposure and resilience of funding strategies consider analysis of investments, liabilities and the 'covenant' provided by those contributing entities (including their ability to support contributions).

We note that our experience in advising private pension schemes through the climate-reporting process has found that often the most exposed element of a schemes' funding strategy is the covenant, given the inability for covenant risk to be materially diversified away. We therefore reiterate that covenant climate risk should be explicitly considered (where relevant).

Question 3: Scenario analysis

We agree with the proposed scenarios.

We also see merit in a 'usable' scenario or forecast; as well as 'book-end' scenarios, scheme decision-making will benefit from a scenario that is probable. As such, we recommend:

- The DLUHC provide further guidance on a disruptive "policy response forecast", such as the PRI's Inevitable Policy Response programme.

Question 4: Risk management?

We agree with the proposed regulations.

Question 5: Metrics

We agree with the proposed metrics. In our experience, the first challenge is obtaining and aggregating holdings data, but that proportionate data solutions exist once an understanding of the portfolio has been

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established.

The second challenge is the interpretation of the metrics to support strategic decisions. We note the considerable variability in disclosure resulting from differing methodologies. In particular:

- Incomplete or poor-quality corporate disclosures, in particular, scope 3 emissions
- “Black box” service provider methodologies, in particular, on physical risks

We recommend the DLUHC work cross-ministry and cross-regulator to address these issues. We agree that this does not prevent AAs preparing TCFD reports in the interim.

We also welcome the inclusion of alignment metrics, but we recommend that DLUHC work with the FCA and others to support LGPS in measuring portfolio alignment; we would favour that alignment goes beyond net zero targets and looks at where those targets have been SBTI reviewed.

Question 6: Targets

We agree with the proposed regulations.

Question 7 & 8: Reporting

We generally agree with the proposed reporting framework; but note the lack of clarity on the structure of the Climate risk report may lead to inconsistency and a lack of easy comparability across AAs. It may therefore be preferable to split the Climate risk report into two sections, one of which must specifically be addressed to non - specialist stakeholders and focuses on key takeaways that can be easily compared across other schemes.

In addition, we note that whilst it is not realistic to undertake a comprehensive scenario analysis on an annual basis, any significant changes could impact member outcomes.

As such, we recommend that the annual Scheme Climate Risk report should confirm that no material changes have been identified which could affect the Scenario Analysis.

Question 9: LGPS asset pools

We agree that there are significant benefits to LGPS asset pools, especially from the perspective of investment strategies.

However, given the different profile and nature of the employers of the AAs, the funding strategies may be considerably different. Care should therefore be taken to outline how the funding strategies and investment strategies are aligned (or to highlight where they do not).

Question 10: Guidance

We agree with the proposed approach.

Question 11: Knowledge, skills and advice

We agree with the proposed approach.

Question 12: Protected groups

We have no additional comments.

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