Cheshire Pension Fund response to the consultation questions on the governance and reporting of climate change risks

Q1. Do you agree with our proposed requirements in relation to governance?

SOMEWHAT AGREE

We welcome the release of these proposals from the DLUHC as part of the 'ecosystem' of regulatory climate disclosures between issuers, asset managers and asset owners in the UK (and increasingly in other jurisdictions globally). We are pleased to see the TCFD framework used, which brings a level of consistency to the structure of disclosures and will thus be helpful for all users.

We support the view that the requirements for the LGPS should be set at the same standard as those for private sector schemes.

We also welcome references to the forthcoming Sustainability Disclosure Requirements (SDR) regime and specifically how these proposals serve as the first step on the journey to implementing the new regime. While TCFD disclosures are useful in understanding the impact of climate on investment portfolios, it is important to also understand the impact of investments on the environment (including climate) and wider society, which the SDR regime and proposals for transition plans, will hopefully bring.

We agree that the oversight of climate risk is very important. Governance arrangements should be clearly recorded and communicated to stakeholders. The communication of governance arrangements should provide comfort that these risks are being managed robustly. Roles and responsibilities should be explicitly defined, and accountability established.

Cheshire Pension Fund already has processes to report climate risks to the Pension Fund Committee and to publish the TCFD report on our public website.

Climate risk should be treated as any other investment risk with a material financial impact to which a fund is exposed. However, we recognise the challenges associated with overseeing this complex risk in practice. Analytical methods and data are evolving and challenging experts on this specialist and nuanced subject is difficult. Advisors need to have a combination of climate knowledge and investment knowledge to be able to advise on the impact of climate change on investment returns. Critiquing the work of externally appointed experts who have been appointed for their specialist expertise and ability to fill knowledge and skills gaps is complex. The Pension Fund utilises our asset pooling company for many aspects of climate risk analysis and reporting and the limited number of credible alternative external parties currently able to provide these capabilities is likely to make any additional appointment by the Fund difficult to secure and expensive.

Guidance is required on the frequency with which Funds are expected to assess climate-related risks, and whether this exercise is expected on a more frequent basis that is required to support our annual TCFD report.

This section appears to focus on governance and advisors and does not explicitly reference investment managers, i.e., those tasked with making investment decisions on behalf of the Fund and integrating an assessment of climate risk into their investment processes. Cheshire Pension Fund believes it is important that mandates accurately reflect climate risk expectations and that these mandates are delivered upon. Once a mandate has been established, discretion for selecting investments resides with the appointed manager. Establishing a mechanism for the oversight of the execution of this discretion is critical and could usefully be incorporated alongside existing manager performance oversight delivered by Pool Companies.

We agree with the acknowledgement that data availability remains a challenge, and we think that the requirement to report metrics 'as far as able' is a pragmatic approach for now, given the urgency to act on climate change and its impacts. We do suggest that further thought may need to be given to where Funds source suitable data from. Procuring climate data at scale from commercial providers is expensive and may be inefficient, particularly if it is done multiple times for the same assets by different Funds. Standardisation of disclosures by asset managers themselves (through the FCA requirements) will hopefully help with this but may not entirely solve it.

CHESHIRE PENSION FUND

Q2. Do you agree with our proposed requirements in relation to strategy?

SOMEWHAT AGREE

Cheshire Pension Fund agrees that the implications of climate change for investment and funding strategies requires regular assessment, but we are unclear on how this would work on a "continuous" basis. Clear guidance would be welcome. We review our investment strategy formally on an annual basis, including assessing the impact of climate risk on the strategy. Investment specific risks or new opportunities would not be regarded as 'strategic', and we expect our investment managers to assess these on an ongoing basis.

We agree that both physical risks and transition risks need to be considered, that these risks have the potential to impact both funding and investment strategies, and that climate change presents both risks and opportunities. We should recognise that climate risk at company and portfolio level is not entirely captured by backwards looking emissions metrics data.

Carbon emissions data observed in isolation is not sufficient to capture all climate risks and opportunities, and therefore we recommend that a wider range of ESG factors should be considered when Funds make asset allocation and investment decisions.

With regard to the recommendations on strategy disclosures, it has been proposed that one of the two scenarios must be Paris-Aligned and the other one will be at the discretion of the Fund. However, no information has been provided on what Funds should consider in selecting the second scenario. We would welcome the inclusion of this information within the statutory guidance that the DLUHC aims to provide to assist Funds to fulfil these new requirements. Consideration should be given in aligning the requirements for scenario analysis with those expected of asset managers.

CHESHIRE PENSION FUND

Q3. Do you agree with our proposed requirements in relation to Scenario Analysis?

AGREE

Cheshire Pension Fund agrees that climate scenario analysis should become an integral and important element of the regular Fund valuation cycle and be carried out at least every three years in line with the triennial valuation cycle. We also agree that at least two climate scenarios should be performed, one of which assesses the impact of a Paris aligned outcome i.e., well below 2 degrees, and at least one that assesses higher levels of global warming, i.e., a potentially more realistic failed scenario. As investors it is important that we assess the implications of possible outcomes as well as desirable outcomes.

Cheshire Pension Fund welcomes the proposal from DLUHC to provide statutory guidance on scenario analysis, especially around missing or poor-quality data inputs. We recognise the best endeavours basis of the scenario analyses currently undertaken and that the area will need to evolve in line with the availability of better-quality data sets in future. Ideally the analyses should be able to provide clearer sector and regional insights that can better inform asset allocation decisions.

Q4. Do you agree with our proposed requirements in relation to Risk Management?

AGREE

Cheshire Pension Fund agrees that climate (and wider ESG) risks and opportunities should be considered as part of regular risk management processes, by Funds, their pools, and external investment managers. Specific climate scenarios analyses will be an important part of these processes.

Collaboration between investment risk experts and climate experts will be needed if climate risk analysis is to be fully integrated into overall risk management. Actuaries will have a key role in developing this expertise.

On the investment side, the investment manager has a critical role to play, whether they be internal or external, and therefore an assessment of the managers climate risk management capability is important.

On the liability side, climate risk should be embedded into risk modelling processes. It is our view that further evolution of data and modelling techniques is required.

CHESHIRE PENSION FUND

Q5. Do you agree with our proposed requirements in relation to metrics?

SOMEWHAT AGREE

Scope 1, 2 and 3 emissions

Cheshire Pension Fund agrees that Funds should be required to measure and disclose the 4 suggested metrics based on total investment assets:

- Total carbon emissions
- Carbon footprint
- Data quality
- Paris Alignment

The Fund also agrees with the requirement to analyse scope 1,2 and 3 absolute emissions on an annual basis. We are cautious of the practical difficulties of accessing reliable scope 3 data for all asset classes. Scope 3 emissions are currently not widely reported, and the estimation of scope 3 emissions can be complex leaving scope for inconsistent techniques across different data providers. They are also much more difficult for a company to control, and progress on scope 1 and 2 emissions may be obscured.

A sensible compromise may be to use the sectoral phase-in of Scope 3 data as required in the Partnership for Carbon Accounting Financials (PCAF), which sees only mining, oil and gas scope 3 emissions included initially. This framework is recommended for use by the TCFD.

Adding scope 1,2 and 3 emissions together:

- introduces a problem of double counting, i.e., one company's scope 1 and 2 emissions are another company's scope 3 emissions. Care will need to be taken to avoid this double counting and to ensure that Funds take a consistent approach. Provision of statutory guidance of the methodologies to be adopted would be helpful in this area.

- means that estimated data may obscure actual data particularly as in some asset classes and sectors scope 3 emissions will dwarf scope 1 and 2 emissions.

Scope 1, 2 and 3 emissions alone do not provide a complete reflection of the transition risk and physical risk exposure of a fund. Nor do these metrics capture all of the upside opportunities. This will need to be explained when presenting the results of this analysis.

Absolute Emissions Metric: Total Carbon Emissions

Cheshire Pension Fund supports the reporting of total carbon emissions at an aggregated level across different assets classes to produce a Fund level number. However, it is likely that significant reliance on estimated emissions data will be required. As real data becomes available the aggregated emissions numbers will fluctuate as real emissions data replaces estimated. It may be beneficial to provide an asset class breakdown which could then be accompanied by some commentary about the reliability of the data and any particular drivers in a Fund's investment strategy.

Different Funds with different levels of maturity will have different attitudes toward risk, this will be reflected in their asset allocations and their carbon footprints. This will need to be considered when comparing different Funds, if comparability is an objective.

The total absolute emissions of a Fund are also heavily influenced by the size of that Fund. Carbon intensity metrics that use the market cap of the Fund will fluctuate in accordance with market valuations. As such, the carbon footprint of a Fund will be influenced by factors other than the carbon emissions of the underlying investments.

Private Markets, Real Estate and Sovereign Bonds present some data challenges in terms of both apportioning emissions to investment portfolios i.e., based on % ownership and splitting emissions across scope 1, 2 and 3. We believe statutory guidance in this area will be required to ensure consistency of reporting across different Funds.

We expect fund managers (external and internal) to assess and understand these risks in detail through their ESG integration processes. Funds and pool companies should assess the performance of fund managers in this regard.

The requirement to produce annual Fund level numbers is likely to place additional demands on existing resources, particularly for those Funds that are already committed to scrutinising and reporting carbon data at a more granular level for existing Climate Risk Reports and committed to reporting progress toward Net Zero objectives.

Supporting guidance to drive better consistency in attributing carbon emissions to investments would be welcome.

Emissions Intensity Metric - Carbon Footprint (calculated by dividing Total Carbon Emissions by total Fund assets)

Previously the carbon intensity metric Cheshire Pension Fund has used has been the Weighted Average Carbon Intensity which is relative to the turnover of the companies invested in. This was selected because it gives an indication of the level of risk to our investments arising from the potential for carbon taxes or similar.

It is not clear of the purpose of the proposed metric or how it helps Funds to monitor or manage their risk. There is a risk instead that this will lead to comparisons of Funds where one with a low score is regarded as better than a Fund with a higher score, ignoring any potential benefits that the Fund is driving through engagement or improvements in practice. This could incentivise Funds operating exclusion policies in contradiction to the stated aims of the approach which explicitly emphasises that this is not the desired outcome. The total absolute emissions of a Fund are heavily influenced by the size of the Fund. Carbon intensity metrics that use the market cap of the Fund will fluctuate in accordance with market valuations. As such, the carbon footprint of a Fund will be influenced by factors other than the carbon emissions of the underlying investments. It will be challenging to explain these changes when reporting aggregated emissions at Fund level.

Cheshire Pension Fund considers that a dashboard of metrics is required to understand the trajectory of a portfolio in terms of carbon emissions. Intensity metrics are important as they provide context for absolute emissions and portfolio / asset class level metrics provide an explanation to Fund level changes. They should be considered together rather than in isolation.

Carbon intensity metrics can be a product of AUM growth or revenue (whichever is used to normalise the absolute emissions). Therefore, it is important that this metric is considered alongside absolute emissions.

Cheshire Pension Fund agrees with the proposal that Funds should calculate and report their Carbon Footprints annually as part of their annual Climate Risk Reports and that separate calculations are performed for Scope 1, scope 2 and Scope 3 emissions.

Cheshire Pension Fund considers that:

- More granular Carbon analysis (at portfolio and company level) allows greater understanding of climate risk exposures and better facilitates individual Fund actions to address these risks.
- Funds should continue to calculate and report alternative metrics such as Weighted Average Carbon Intensity (WACI) as well as Fund level carbon footprint metrics

WACI enables a comparison of the carbon intensity of a portfolio with the carbon intensity of its benchmark, and comparison across different portfolios as the WACI is both a product of the carbon intensity of the companies in the portfolio and the size of the of the investment in those companies. WACI is useful from a risk perspective, as it provides a portfolio-weighted exposure to emissions in a manner like other measures of investment risk, such as market beta. WACI can be considered a proxy for the risk of carbon pricing. As such we consider that Funds should continue to analyse these metrics at portfolio level and disclose this analysis to stakeholders. Some Funds may have set decarbonisation targets based on WACI as such they will continue to analyse this number and report on it. Also, WACI is a core (and under FCA rules, mandatory) metric used by asset managers that gives a good indication of exposure to high carbon intensity holdings.

Data Quality Metric – the percentage of assets for which Scope 1, 2 and 3 emissions are verified, reported, estimated or unavailable

Cheshire Pension Fund agrees that it is important to report the quality of the data that has been used to produce Climate Risk Reports and TCFD disclosures. This metric will provide valuable context for the reliance that can be placed on any reported aggregate numbers, at either Fund or LGPS total scheme levels. We further support the proposal to issue guidance setting out how Funds should assess and disclose the quality and availability of data.

The difficulty in managing data in certain asset classes should be recognised, for example disclosure in emerging markets, small cap and private markets tends to be lagging. Consequently, figures will often be driven by strategic asset allocations. There is a risk that local investments in smaller companies and private assets could be discouraged. Furthermore, the reporting is challenging as some private equity funds have excellent reporting, but there seems to be no central way for this to be recorded. Consequently, reflecting this information at Pension Fund level can only be done with manual input which cannot be resourced, and even then would likely only be partial and inconsistent information. It is hoped that greater consistency of reporting will also drive better reporting by

CHESHIRE PENSION FUND

companies and Funds. Increased regulatory requirement for companies and Funds to disclose this information would support this initiative, alongside investor efforts to achieve greater disclosure across asset classes through engagements and voting. In addition, it can be hard to apportion emissions from private assets as it isn't always possible to identify what proportion of a fund is owned. This disclosure would also be required to enable the suggested reporting.

We agree that in the absence of mandated company reporting, it will be challenging for Funds and Pool Companies to obtain comprehensive underlying data across all asset classes. Where data is not available, we would support the use of estimated data, but with the caveat of the degree of uncertainty that this inevitably introduces.

Paris Alignment Metric

Cheshire Pension Fund agrees with the TCFD recommendation that financial institutions report alignment with the carbon reduction goals set in Paris, despite the current shortcomings with the data available in this area.

We also strongly support:

- The necessity for forward-looking metrics to enable active decision making now.
- That an imperfect metric now is better than having no metric at all.
- The need for statutory guidance in this area to ensure consistency of reporting across the LGPS
- Encouragement of Funds to calculate additional Paris Alignment Metrics where they would be useful to the understanding and decision-making effectiveness for climate risk management.

We consider that not all Net Zero commitments / targets are the same, some are more challenging and comprehensive than others. Consideration needs to be given to the detail of the commitment and the company's ability to deliver it. A binary metric could miss this important nuance. Therefore we disagree with the proposed Binary Target Measure as the most appropriate for the LGPS. The simplistic nature of this metric could give a misleading impression to stakeholders in respect of the robustness of the targets set by investee companies.

We also disagree with the proposal for reporting only a single top-level figure for Paris Alignment. We believe that additional, more granular data would allow greater understanding of Fund climate risk exposures and better facilitate individual Fund actions to address these risks. A net zero target quality score at portfolio / fund level should also be considered.

Funds that have already made Net Zero commitments will need to consider how best to measure and report their pathway towards Net Zero. This is likely to involve consideration of the decarbonisation trajectory of the most carbon intensive assets in the portfolio and a comparison against the decarbonisation profile of the relevant sector. It is also important to make a distinction between metrics that are focused on measuring the impact of the portfolio and those metrics that are intended to provide insights into the risk exposure of the portfolio.

Implied Temperature Rise (ITR) metrics are often a point in time analysis and do not necessarily give a strong indication of how a company or portfolio might look in 3 years' time for example. They do not necessarily give an indication of the direction of travel in terms of carbon, nor do they necessarily assess the potential for an individual company's product portfolio to contribute to the transition in a positive way. Cheshire Pension Fund believes it is important to take a broad set of factors into consideration when making investment decisions looking at a company's strategy, R&D spend, CapEx plans, the progress of technological innovation and the pipeline of regulation and legislation. It is important to be clear and transparent about the limitations of these metrics when presenting results.

Investors can play an important role in encouraging companies to disclose more data around climate risks and ESG risk more generally. However, we consider that there is also a critical role for government in mandating this disclosure. Engagement can only achieve so much.

There will be a challenge ensuring that all of these metrics are explained properly to stakeholder groups and in dealing with queries and questions around methodology, data and alignment. This in itself will present a significant drain on Fund resources.

Q6. Do you agree with our proposed requirements in relation to Targets?

SOMEWHAT AGREE

Cheshire Pension Fund agrees with the proposal that AAs should set a target for their Fund. We consider that any targets set for Climate Risk Reporting should be aligned to achieving Net Zero; an approach consistent with the UK Government's stated objectives and ambitions agreed in Paris.

We believe that to achieve comparability between Funds and across LGPS, consideration should be given to mandating the use of a target or targets, rather than allowing Funds freedom of choice, and would welcome statutory guidance on this matter.

Targets should be aligned to achieving Net Zero, an approach consistent with the UK Government's stated objectives and ambitions agreed at Paris. We believe that the transition to Net Zero will not be linear in terms of the decarbonisation of the real economy. Events such COVID-19 and the invasion of Ukraine can change international priorities in the short-term, which affect market views of sectors and sector performance. However, the importance of the longer-term decarbonisation of the real economy is clear. As such, Cheshire Pension Fund favours medium and long-term targets which we consider would better reflect non-linear decarbonisation progress than annual targets. Medium or long-term targets will still need to be measured and monitored annually, however we consider that mandating an annual target could prove to be a distraction from the achievement of the longer-term economy wide ambitions which we consider to be compatible with our fiduciary responsibilities.

Any reporting against targets should be accompanied by the data coverage of AUM. We also believe that it would prove problematic to change targets once they have been set and published. It is not clear what circumstances would justify changing targets. We believe our preference for longer dated targets would negate the risk of setting unachievable annual targets that need to be changed.

Implementation of a target across all asset classes would currently be challenging as robust and available data is not comprehensive.

In the near term it may be most appropriate to set targets focussed on liquid asset classes such as equities and fixed income. Targets which include other asset classes could follow as data coverage and quality improves.

Cheshire Pension Fund supports the expectation that Funds should NOT set targets which require them to divest. We strongly advocate engagement in advance of divestment. Divestment remains an option, however these decisions should be taken following robust analysis that integrates ESG Analysis and Financial analysis.

CHESHIRE PENSION FUND

Q7. Do you agree with our proposed requirements in relation to Reporting?

AGREE

Cheshire Pension Fund supports the proposal that each AA publishes a Climate Risk Report every year, and that these reports should be easily accessible and cater for the needs of both specialist and lay readers. We agree with the proposed disclosure requirements for annual Climate Risk Reports.

We consider the oversight of governance activities to be critically important. We therefore agree with the proposal to mandate the reporting of governance frameworks for the management of climate risk.

However, this section does not cover the oversight of investment management activities, specifically the integration of ESG into investment processes, and the delivery of stewardship and voting. We consider the oversight and governance of investment management activities to be of significant importance, and therefore recommend the reporting of governance arrangements pertaining to this. Scope 1 and scope 2 carbon emissions on their own do does not provide a complete picture of a fund's exposure to Transition risk and Physical risks, and we believe these risks should be reflected in reporting.

We consider that reporting annual performance against medium and long-term targets such as the 2030 and 2050 targets associated with Net Zero will create additional challenges both in terms of report generation and communication. The transition to a lower carbon economy will not be linear and investment mandates are not necessarily managed over medium / long term horizons even though pension funds are considered long term investors. However, we see the benefits of this reporting for stakeholders. Cheshire Pension Fund already publishes a TCFD risk report with the assistance of our pool company. Each of the pool partner Funds has a schedule for this report across the financial year. Setting a deadline in line with the annual report will concentrate all the work into half of the year and it will be difficult for the pool to meet these deadlines without additional resources.

Q8. Do you agree with our proposed requirements in relation to Scheme Climate Risk Report?

SOMEWHAT AGREE

We agree that Total Carbon Emissions and Carbon Footprint should be calculated and reported at an aggregate level. We recognise the merits of an overall LGPS Scheme Climate Risk Report. However, we consider that it would be very challenging to achieve in practice across all asset classes. A robust and meaningful scheme level report would require consistent carbon assessment methodologies across Funds and pools which we believe would need to be mandated through detailed statutory guidance.

This question also proposes each AA must report the proportion of its assets for which overall emissions data is Verified, Reported, Estimated or Unavailable (data quality metric). We agree with this requirement subject to data vendor classification methodologies, however there may be differences in data quality beyond these reporting criteria. Not all estimation models are equal, some vendors will correct some data that they consider to be erroneous, and some vendors correct data retrospectively.

It may be difficult to explain how and why a scheme level number is changing over time. Some disaggregation of the data will be required to understand these trends and whether changes are driven by data, disclosure, increases in AUM or real decarbonisation of portfolio companies.

The Scheme Climate Risk Report will be reliant on estimated data particularly in respect of scope 3 carbon emissions. Methodologies for estimating scope 3 emissions vary and as such the accuracy of this number will be compromised. Year on year changes may be down to changes in estimation methodologies or the transition from estimated data to reported data as much as they are explained by changes in real emissions. This will need to be explained when the numbers are disclosed.

At some point in the future, we may encounter some emissions data that is reported net of offsets and consideration will need to be given as to how this "Net" data is assimilated into existing data set.

We consider that a scheme level Paris alignment metric would provide some indication as to the percentage of AUM that have committed to a Net Zero target. We are concerned that there is potential for this metric to be misinterpreted. Not all Net Zero targets are equal and not all companies are progressing toward the achievement of their targets at the pace required. We consider that a more nuanced approach to assessing a company's alignment such as Net Zero Zeal would give a more insightful indication of progress.

A dashboard of metrics is required to understand the trajectory of a portfolio in terms of carbon emissions. Intensity metrics are important as they provide context for absolute emissions and portfolio / asset class level metrics provide an explanation to Fund level changes. They should be considered together rather than in isolation.

If these issues can be resolved then we are supportive of the Scheme level reporting. The LGPS is transparent, and all this information will be in the public domain. The risk of being compared unfairly is significant and the resource requirements for those schemes in that situation should not be overlooked.

CHESHIRE PENSION FUND

Q9. Do you have Comments on the role of the LGPS asset pools in delivering the requirements?

Cheshire Pension Fund's pooling company currently provides climate risk reporting and scenario analysis to their partner funds covering both their pooled and non-pooled assets. This has enabled partners funds within the Central pool to develop their climate risk reporting in a co-ordinated and efficient manner.

It should be recognised that the governance of each LGPS scheme rests with a democratically elected body responsible for managing the scheme. This should not be changed.

However, we believe that a commonality of approach and comparable targets would make it easier for pooling companies to support Partner Funds and provide analysis that is useful to all. This would also help to reduce the impact and cost of reporting across the pool.

Q10. Do you agree with our proposed requirements in relation to approach to Guidance?

SOMEWHAT AGREE

Clear and comprehensive guidance is essential if there is an intention to make reporting comparable and consistent at scheme level, i.e. across Funds and pools. As discussed above reporting Scope 1, 2 and 3 emissions at Fund level presents a number of practical and philosophical questions that have significant implications for the resulting numbers.

We agree if scheme level reporting is required, the absence of such guiding documents may compromise the consistency and comparability of reporting. Clear, comprehensive, and detailed guidance is essential if there is a desire to harmonise climate governance standards and an intention to make climate reporting comparable and consistent at scheme level (i.e., across Funds and pools). Provision of only "high level" guidance risks compromising consistency and comparability.

Reporting Scope 1,2 and 3 emissions at Fund level presents a number of practical and philosophical questions that have significant implications for the resulting outputs. For example, if datasets and reporting approaches change this will be reflected in year-on-year carbon performance and therefore it is important to adopt a robust approach from the out-set. We agree that a standard template may be the most effective way to collect data and ensure consistency. The template should reflect existing best practices to the extent possible and facilitate and encourage consistency.

Q11. Do you agree with our proposed requirements in relation to knowledge, skills, and advice?

AGREE

Cheshire Pension Fund is advised by our Pool company on these services. LGPS Central currently provides advice to its partner Funds on the management of climate risk. Pools could provide assistance in respect of procurement and centralised contracts can help to keep costs down.

In the absence of recognised climate related qualifications, it is difficult to define base knowledge. Climate related scenario analysis can also be complex. The CFA ESG qualification appears to be gaining traction as a standard qualification for investors. However, this is high level.

CHESHIRE PENSION FUND

Q12. Do you have any comments on the impact of our proposals on protected groups and on how any negative impacts may be mitigated?

Cheshire Pension Fund shares your belief that there would not be impacts on protected groups from the proposals in this consultation.