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CLIMATE RISK AND THE PENSION SCHEMES ACT

Governance, Sustainability & Society – Part of the Horizon Scanning series

Subject to approval by Parliament, detailed new requirements for trustees of larger occupational pension schemes to manage, and disclose their approach to, climate-related risks and opportunities, will come into force in October 2021. The proposals are part of efforts by the Government to encourage businesses, asset managers, financial institutions and others to deepen their engagement with climate-related issues. The new governance and disclosure requirements are in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD - see box below on **TCFD recommendations**), adjusted to make them work in a pension scheme context. Whilst initially applying to large schemes, schemes of all sizes will need to consider their governance of climate risk in the light of the proposals.

The proposals were finalised by the DWP in January 2021, in a response to consultation. The response includes a further consultation (until 10 March 2021) on two sets of implementing Regulations under the Pension Schemes Act 2021 (the Act) and draft statutory guidance for trustees on governance requirements and disclosure (the Guidance).

This bulletin covers the key points arising from the DWP's proposals, on the assumption that no changes are made between the versions of the Regulations and Guidance on which the DWP is consulting and those that come into force later this year.

Context

Pension schemes (and their sponsors) are potentially exposed to two types of climate-related risks: physical risks (such as extreme weather events, changes in sea levels and other gradual changes in climate) and transition risks (risks associated with action to tackle climate change, such as changes in government policy, technology and consumer preferences). Climate risks are one part of a broad range of environmental, social and governance (ESG) factors against which trustees of occupational pension schemes can assess their investments (see box below on **ESG factors**).

It should be noted that the TCFD recommendations (and hence the legislation underpinning the new regime) refer to "climate-related risks and opportunities". The TCFD recommendations suggest that climate-related opportunities may include access to new markets and technologies related to the transition to a low-carbon economy; a reduction in operational costs and exposure to price increases; and reputational benefits.

Although the Government has signalled a wider policy aim in relation to ESG (the launch of its Green Finance Strategy in 2019, for example), the Act itself does not go beyond climate-related risks and opportunities (referred to in the rest of this bulletin as "CR"). However, there are already provisions on what a scheme's Statement of Investment Principles (SIP) must disclose about financial and non-financial factors (see box below on **SIP requirements**). The Government's view is that, under its proposals for a new governance and disclosure regime, trustees will move away from the relatively high-level disclosures prescribed in the SIP to demonstrate how the consideration of CR is integrated into trustees' decision-making, thereby providing greater transparency to members and beneficiaries about how investments held by the trustees on their behalf are being managed.

It is not completely clear whether the Government's primary motivation is to ensure that CR (including, in particular, transition risk) is properly reflected in the market values of assets, or goes further to the wider issue of investing in specific ESG assets such as impact bonds. Given the speed at which ESG has risen up the regulatory agenda, trustees may feel under pressure to consider wider ESG factors as part of their investment considerations. Further pressure may come from scheme sponsors or the perception of the importance this has for scheme members. However, this is a separate topic from CR and one where trustees need to tread carefully because of the risk of challenge if it were to involve giving up some level of investment return.

ESG

Under the United Nations Principles of Responsible Investment, ESG factors include:

- **Environmental issues:** sustainable land use, plastics, water, fracking, methane, biodiversity ("climate change" is not listed as a specific category, being relevant to the majority of these factors)
- **Social issues:** human rights and labour standards, employee relations, conflict zones
- **Governance issues:** tax avoidance, executive pay, corruption, director nominations, cyber security.

TCFD recommendations

TCFD is a global, private sector group assembled at the instigation of the International Financial Stability Board. In 2017, the TCFD published recommendations designed to enable all organisations, financial and non-financial, to produce information on the financial impacts of climate change. The Government's policy objective has been to encourage compliance with the TCFD recommendations on a voluntary and, gradually, a compulsory basis.

The TCFD recommendations are split into four categories of recommended disclosure:

- Governance (oversight and management) of climate risks
- Strategy: actual and potential impacts of climate risks on businesses, strategy and financial planning
- Risk management: how climate risks are identified, assessed and managed
- Metrics and targets used to assess and manage climate risks.

SIP requirements

The requirement to record the consideration of ESG factors in a scheme's SIP has been contained in the Investment Regulations since 2005. Prior to 1 October 2019, the regulations stated that a SIP needed to cover the extent (if at all) to which "*social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments*". This was amended in 2019 to include new disclosure requirements. From 1 October 2019, trustees of affected schemes have had to set out:

- how they take into account "financially material considerations", which include ESG factors (including "climate change"), over the length of time that the trustees consider is needed for the scheme investments to fund future benefits;
- their policies in relation to stewardship; and
- the extent (if at all) to which "non-financial matters" (broadly, members' and beneficiaries' views, including on ESG) are taken into account.

From 1 October 2020, the trustees must also explain how their arrangements with the scheme's asset managers incentivise alignment of the investment strategy with the SIP, and include an implementation statement setting out how the SIP has been followed during the year. (The requirements for DB schemes are more limited.)

Trustee obligations under the new regime

The legislation underpinning the new regime is set out in the Act and in Regulations made under the Act. As described in detail below, under **What trustees will need to do**, the Regulations impose climate risk governance and reporting requirements on trustees of schemes in scope (see **Scope and timing** below). The Regulations require trustees of schemes in scope to have regard to Guidance ("statutory Guidance") which sets out how they should meet the requirements and report in line with the TCFD recommendations. Trustees can diverge from the statutory Guidance, but will have to explain why they have done so in their annual TCFD report (see **TCFD report** below). (One part of this Guidance, relating to trustee knowledge and understanding, is not in fact statutory – see below.)

The draft statutory Guidance recommends that trustees refer to another set of guidance that the DWP published at the same time: non-mandatory guidance from the Pensions Climate Risk Industry Group (PCRIG, an industry group set up by the DWP and the Pensions Regulator (TPR) to help trustees meet their legal responsibilities in relation to CR - see box below on **Guidance from the Pensions Climate Risk Industry Group**). This non-mandatory guidance advises trustees (of schemes of all types and sizes) on how they can integrate climate issues into their existing governance processes.

Trustees are required under the Regulations to carry out scenario analysis and obtain data to calculate their metrics "*as far as they are able*". This recognises that there may be gaps in the data trustees are able to obtain about scheme assets for the purposes of carrying out scenario analysis or calculating metrics. Additionally, in the case of DB schemes, there may be limitations in the analysis they can carry out in relation to their liabilities or funding strategy (for example, the sponsoring employer's covenant). "*As far as they are able*" is defined in the Regulations to mean taking all steps as are reasonable and proportionate in the particular circumstances, taking into account the costs to the scheme and the time to be spent by the trustees or anyone acting on their behalf. The statutory Guidance gives examples of how this will operate:

- If trustees are able to obtain data or analysis only at a disproportionate cost, they may make the decision to treat this data as unobtainable. A "robust justification" for doing so should be set out in the TCFD report.
- Trustees may need to use modelling or estimation, take a qualitative instead of quantitative approach, or proceed with scenario analysis for part of their portfolio or for certain liabilities only. Trustees should explain in their TCFD report the extent to which they were able to obtain the data and other information needed to carry out the scenario analysis or metrics and explain any gaps.
- If trustees are using third party providers for scenario analysis, calculation of metrics, or measuring performance against targets, the trustees should make sure that they are provided with sufficient information to be able to report on this.

In most cases, trustees will not themselves be carrying out the underlying climate risk activities, or implementing investment strategies. However, as trustees are ultimately responsible, the Regulations require the trustees to establish processes to satisfy themselves that anyone to whom they delegate governance activities, or external advisers (other than legal advice), "takes adequate steps to identify, assess and manage" CR.

In addition, the Regulations require trustees to have an appropriate degree of knowledge and understanding of the principles relating to the identification, assessment and management of CR. The section of the Guidance which covers trustee knowledge and understanding has no statutory force

- although encouraged to have regard to it, trustees are not required to do so and are not expected to provide an explanation in their TCFD report if they choose not to follow this section of the Guidance. It explains that an appropriate degree of knowledge and understanding means understanding how scenario analysis works, why climate change poses a material financial risk and its relevance to overall risk management, as well as being able to interpret the results of analysis and challenge assumptions and external advice.

Scope and timing

The new regime will apply initially to larger occupational pension schemes, authorised master trusts and collective DC schemes. Occupational pension schemes with £5 billion or more in "net assets" on the first scheme year end date on or after 1 March 2020, as well as all authorised master trusts and all collective DC schemes (as at 1 October 2021), will be required to:

- have a system of climate governance in place on 1 October 2021 (although the date can be later if no audited accounts have been obtained); and
- publish an annual TCFD report, the first report within seven months of the end of the scheme year underway on 1 October 2021. (See **TCFD report** below.)

The following year, these requirements will be extended to schemes with assets of £1 billion or more. Where scheme net assets exceed £1 billion on the first scheme year to end on or after 1 March 2021, the governance requirements will apply from 1 October 2022 (subject to obtaining audited accounts) and the TCFD report will be due seven months after the end of that scheme year. The timing is summarised in the box below.

"Net assets" means those attributed in the annual report and accounts, less any external liabilities (i.e. other than liabilities to pay pensions and benefits). Buy-in contracts are excluded from net assets.

Schemes will remain in scope until their net assets fall below £500 million at scheme year end. There will be an interim review, in the second half of 2023, when the DWP will consider whether, "in the light of the falling costs of climate change assessment", the requirements should be extended to smaller schemes from late 2024 or early 2025.

Date new regime first applies	Governance	First TCFD report
Scheme net assets are at least £5 billion on first scheme year end date on/after 1 March 2020.	Governance requirements apply from 1 October 2021. (However, if audited accounts are obtained later than that date, the requirements apply from the date the audited accounts are obtained.)	Trustees must publish within 7 months of the end of the scheme year which is underway on 1 October 2021; and include a link in the annual report and accounts for that scheme year.
Scheme net assets are at least £1 billion on first scheme year end date on/after 1 March 2021.	Governance requirements apply from 1 October 2022. (However, if audited accounts are obtained later than that date, the requirements apply from the date the audited accounts are obtained.)	Trustees must publish within 7 months of the end of the scheme year which is underway on 1 October 2022; and include a link in the annual report and accounts for that scheme year.

What trustees will need to do

Trustees will be required to put in place measures in a number of areas. This may involve amending existing terms with fund managers or other investment providers. In particular, trustees will have to:

Governance

- Establish and maintain oversight of CR relevant to the scheme. The statutory Guidance explains that the trustees should develop a climate governance structure for allocating roles and responsibilities.
- Establish and maintain processes to satisfy themselves that third parties to whom they delegate, and advisers, are taking adequate steps (see **Trustee obligations under the new regime** above).
- In the annual TCFD report, describe how the oversight is maintained and set out the role of third parties/advisers and the process by which the trustees satisfy themselves that those third parties are carrying out their roles.

Strategy

- Identify, on an ongoing basis, CR that will have an effect on the investment and, in the case of DB schemes, funding strategy of the scheme, over the short, medium and long term.
- In the TCFD report, describe the time periods that they have chosen for the short, medium and long term, the risks and opportunities they have identified and their impact on the scheme's investment and funding strategy.

Scenario analysis

- As far as they are able (see **Trustee obligations under the new regime** above), trustees must carry out scenario analysis in the first year in which the governance requirements apply and then at least every three years thereafter. Trustees must, in the intervening years, review whether they should refresh their analysis, taking account of matters in the statutory Guidance (including increased availability of data, or a significant change in investment or funding strategy) and either carry out fresh scenario analysis or explain in their TCFD report why they have decided not to do so.
- Scenario analysis must assess the impact on the scheme's assets and liabilities, and the resilience of the scheme's investment strategy and funding strategy for at least two scenarios, one of which corresponds to a global average temperature rise of between 1.5 and 2°C inclusive on pre-industrial levels.
- In their annual TCFD report, trustees must describe the most recent scenarios they have analysed and the potential impact.

Risk management

- Adopt and maintain, on an ongoing basis, processes for identifying, assessing and managing CR, and ensure that CR are integrated into the scheme's overall risk management apparatus. The statutory Guidance sets out factors that trustees should take into account when deciding how to prioritise identified risks, based on materiality, including likelihood and financial impact.

Metrics

- Select and (as far as they are able) calculate an "absolute emissions" and an "emissions intensity" metric for scheme assets, both measuring greenhouse gas emissions (GHG). Trustees must also select one additional climate change metric, not directly related to GHG. The statutory Guidance suggests a range of measures, such as implied temperature rise or climate value at risk.
- Review the selection of metrics from time to time as appropriate to the scheme.
- In the TCFD report, describe the metrics and, if the trustees have not been able to obtain data to calculate the metrics for all the assets of the scheme, the reasons.

Targets

- Set a non-binding target for the scheme in relation to at least one of their metrics.
- On an annual basis, measure performance against the target (as far as are they are able) and decide whether to retain or replace the target.

In the TCFD report, describe the performance of the scheme against the target.

Guidance from the Pensions Climate Risk Industry Group

The Pensions Climate Risk Industry Group has published non-mandatory guidance (*Aligning your pension scheme with the TCFD Recommendations*). There are full length and summary “quick start guide” versions for each of the four parts:

1. Climate risk as a financial risk to pension schemes, trustees’ legal requirements and the TCFD recommendations.
2. Trustee governance, strategy and risk management: suggested approach for the integration and disclosure of climate risk within the governance and decision-making processes of pension trustee boards, including defining investment beliefs, setting investment strategy, manager selection, and monitoring. This includes a “top 10 questions for asset managers” and a suggestion that, in the case of passively managed pooled funds, trustees may wish to consider the use of alternative indices that are not based on market-capitalisation weighted indices.
3. Scenario analysis: technical details on recommended scenario analysis. In terms of best practice PCRIG suggest that some schemes will choose to go beyond the minimum requirements set out in the Regulations, although this may not be until their second year of TCFD reporting or later. Trustees may wish to increase the sophistication and granularity of their modelling, incorporating the latest thinking from across the industry. Examples employed by the Lloyds Banking Group and the BBC are provided.
4. Setting metrics and targets to measure climate-related risk. Where gaps in data do exist it should be regarded as preferable for trustees to use modelling or estimation to fill them, rather than to leave them unaddressed. Beginning with estimated or proxy data can help identify carbon-intensive hotspots in lending and investment portfolios, and serves as a benchmark for asset-specific data points as and when they become available. A detailed list of different possible matrices is provided, as well as a further example from HSBC.

TCFD report

The annual TCFD report will include information about how the trustees have implemented the governance measures and the reasons for any departure from the statutory Guidance.

Trustees will have to:

- Publish the TCFD report so it is accessible free of charge on a publicly available website. The Chair of trustees must sign the report, although the signature need not be published.
- Reference the TCFD report in the scheme’s annual report.
- Tell members via their annual benefit statements (via the funding statement, for DB members) that the TCFD report has been published and where they can locate it.

Where the annual benefit statement is issued in advance of the TCFD report for that year, trustees should direct members to the most recently published report, or in the first year, the location where the report will be published in due course.

- Provide TPR with the web address where they have published their most recent TCFD report, via the annual scheme return. Where trustees have not yet published their first report, they must inform TPR whether the period for doing so has ended.

- Provide TPR with the website address of their published SIP and (where applicable) implementation statement and published excerpts of the Chair's Statement, via the annual scheme return form. This applies to all schemes required to publish, not just those in scope for the new regime.

Penalties for non-compliance

Non-compliance is, of course, likely to lead to reputational damage to both scheme and sponsor. In terms of formal sanctions, there will be a mandatory penalty (minimum £2,500) for wholesale non-compliance - i.e. complete failure to publish any TCFD report. Penalties for reports that TPR deems to be inadequate in meeting the requirements of the Regulations will be subject to discretion (maximum £5,000 for individual trustee; £50,000 for corporate trustee). Additionally, requirements to reference the TCFD report in the annual report and to inform members will be subject to the existing penalty regime in the Disclosure Regulations.

Impact of the new regime

Given the nature and likely materiality of the risks posed by climate change, there is a view (expressed by the PCRIG in their guidance) that trustees' fiduciary duties require them to take into account the financial impact of these risks (alongside other risks) when setting investment strategy; and that trustees' duties are not limited to traditional financial risks such as interest rate, currency exchange rate or inflation risks. (In the past, trustees might not have viewed CR risk as a quantifiable financial risk.)

The DWP echoes this view in the response paper. Whilst noting that the Government made clear during debates in Parliament on the Act that the new regime will not, and cannot, be used to direct pension scheme investment, it sees stewardship of assets, including engagement with higher carbon firms and voting at Annual General Meetings (whether directly or via asset managers), as "*entirely legitimate responses*" to climate risks revealed through disclosures.

TPR's guidance on DB and DC investment advises trustees considering investment decisions or setting investment strategy to take into account all ESG and other factors that are financially material to the performance of an investment. On "non-financial factors" (meaning members' views on ESG and other matters) the guidance reiterates the view of the Law Commission (from its 2017 report on pension funds and social investment) that trustees can take these factors into account if they have good reason to think that members share a particular view and their decision does not risk significant financial detriment to the fund.

There is evidence of increasing engagement by members with their schemes on climate risk. In the 2019 Australian case of *McVeigh v Retail Employees Superannuation Pty Ltd*, a pension scheme member brought a legal action against the scheme alleging that the climate change information initially provided to him by the scheme was insufficient to discharge its statutory duty to disclose information. The case eventually settled,with REST releasing a statement acknowledging climate risks to its portfolio and agreeing to climate risk management and disclosure measures and a long-term net zero target for its portfolio. In the UK, a similar complaint was made to the Pensions Ombudsman as a maladministration claim. The Ombudsman held that there was no breach of a positive disclosure duty, either under case law or legislation.

On this issue, the DWP notes: "*Whilst engaged members and civil society groups have an important role in facilitating scrutiny, these measures are not intended to give any support to campaign groups calling for blanket divestment from certain assets.*" If anything, the new regime may be helpful as a protection against challenges.

Whilst the requirements will apply initially to the largest of pension schemes, all pension schemes will need to consider the DWP proposals, not least because considering the financial risks and opportunities identified (and ESG investment more generally) forms part of the core investment duties. Trustees have to comply with those core duties independently of the statutory requirements of the new regime.

This briefing is part of the Slaughter and May Horizon Scanning series

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