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Improving governance and reporting of climate-related issues in occupational pension schemes: Government publishes proposals

Governance and Impact – Part of the Horizon Scanning series

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In August 2020 the Department for Work and Pensions (DWP) published proposals for legislation and statutory guidance on governance and reporting of climate change issues in line with the Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Trustees of larger occupational pension schemes, authorised master trusts and collective DC schemes will be required to (i) address climate change risks and opportunities through effective governance and risk management measures; and (ii) publish an annual report on such measures (to be known as a TCFD report).

Under the proposed new rules, trustees will be responsible for a variety of strategic and risk management activities, including scenario analysis (such as how the scheme's assets would be affected by a global average temperature rise of 2°C above pre-industrial levels); identifying suitable metrics and using them to measure and manage the climate-related risks and opportunities associated with the scheme; and setting targets and reporting on performance against them.

While some of the legislation and statutory guidance will be quite prescriptive, the Government recognises there are unlikely to be sufficient data to allow a full quantitative analysis to be carried out. Trustees will therefore be able to depart from the statutory guidance provided they explain why, and in some cases trustees will be permitted to meet the requirements "as far as they are able" to do so.

Although trustees of smaller schemes will not, in the first few years, be required to comply with the TCFD Recommendations, they will need to address climate risk as part of the scheme investment governance.

Translating the TCFD Recommendations into law and guidance

The new Pension Schemes Bill includes powers to make Regulations:

- imposing requirements on trustees with a view to ensuring that there is effective governance of the scheme with respect to the effects of climate change; and
- requiring information relating to the effects of climate change on the scheme to be published.

The Government proposes to translate the TCFD Recommendations into legislative requirements in the form of Regulations supported by statutory guidance. Although the substance of the TCFD Recommendations will stay the same, some adjustments will be needed to make them work in a pension scheme context. (For more details of the TCFD Recommendations see the Appendix at the end of this briefing.)

Context: the impact of climate-related risks on trustees' duties

Climate-related risks can generally be grouped into two types: physical risks (such as extreme weather events, changes in sea levels and other gradual changes in climate) and transition risks (i.e. risks associated with action to tackle climate change, such as changes in government policy, technology and consumer preferences). Consequences of these risks include business disruption; destruction or impairment of assets; migration of workers; and increases in energy prices.

Pension schemes are potentially exposed to climate-related risks, whether investing in active or passive strategies, pooled or segregated mandates, and over different time horizons. The financial position of sponsors of pension schemes

could also be affected by climate-related developments.

In March this year the Pensions Climate Risk Industry Group (PCRIG), an industry group set up to help trustees meet their legal responsibilities in relation to climate-related risks, published for consultation draft non-statutory guidance on how trustees can integrate climate issues into their existing governance processes, and disclose details of steps they are taking, in line with the TCFD Recommendations. The guidance is aimed at schemes of all types.

Given the nature and likely materiality of the risks posed by climate change, the PCRIG considers 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 climate change risk as a quantifiable financial risk.)

Other regulatory developments are relevant. By 1 October 2019 schemes had to update their Statement of Investment Principles (SIP) to include policies in relation to financially material risks and opportunities. From 1 October this year, trustees will be required to 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 (although the requirements for DB Schemes are more limited). The forthcoming Code of Practice on governance will require trustees to carry out an assessment of whether and how they assess risks, the use of resources and the environment.

As foreshadowed in the Pension Schemes Bill, the DWP has now decided to go further and require trustees of larger occupational pension schemes, authorised master trusts and collective DC schemes essentially to comply with the TCFD Recommendations. The Government will consider whether schemes meeting the TCFD requirements in line with the new Regulations will be deemed also to have met the standards in the Code of Practice on governance insofar as they relate to climate change. However, the Government does not intend the new requirements to dictate trustees' investment decisions. (For further details of what the new requirements will mean for trustees of such schemes see below, "*What trustees will need to do*".)

Trustees of smaller schemes will not, in the first few years, be required to comply with the TCFD Recommendations, but they will need to address climate risk as part of the scheme investment governance. Trustees of schemes of all sizes may find it helpful to refer to the non-statutory guidance published by the PCRIG: the final version is expected to appear soon.

DB vs DC schemes

Trustees of DB schemes will need to consider the financial impact of climate-related risks and opportunities on (i) the scheme's assets and liabilities; and (ii) the covenant of the sponsoring employer(s). The latter will involve considering the scheme's funding levels and employer covenant as part of an integrated risk management (IRM) approach.

Trustees of DC schemes will need to consider the financial impact of climate-related risks and opportunities on (i) the risk/return profile appropriate to the membership; and (ii) the investment risk and returns of the default fund and any applicable member self-select funds. The PCRIG are clearly of the view that trustees must not relegate the consideration of climate change to members via self-select funds.

For further details see below "*What trustees will need to do*".

Scope and timing

The Regulations will initially apply 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 to end on or after 1 June 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 for the relevant scheme year in place on 1 October 2021; and
- publish an annual TCFD report, the first report within seven months of the end of that scheme year under way on 1 October 2021, or by 31 December 2022 if earlier.

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 June 2021, the governance requirements would apply for the scheme year under way from 1 October 2022 and the TCFD report would be due seven months after the end of that scheme year, or 31 December 2023 if earlier.

Schemes would remain in scope until their net assets fall below £500 million at scheme year end. The DWP will consider in 2024 whether to extend the requirements to smaller schemes.

What trustees will need to do

Measures to identify, monitor and manage climate-related issues

Trustees will be required by the Regulations 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 processes to ensure that persons managing the scheme are assessing and managing climate-related risks and opportunities, and that trustees themselves have oversight of climate-related risks and opportunities. The accompanying statutory guidance will include quite prescriptive requirements, including roles and responsibilities, integrating a consideration of climate change into the scheme's existing governance, and the types of processes that trustees should put in place to ensure external advisers or employees are informed about and monitor climate-related issues effectively.

  While some larger pension schemes may invest through a segregated portfolio manager, in many cases trustees will invest through pooled funds. The PCRIG's draft guidance suggests trustees should identify funds and managers which adopt an investment approach aligned with the trustees' investment beliefs. The draft guidance contains a sample list of enquiries to raise with an asset manager. It highlights the important role of the investment consultant. One proposal is that the objectives for the investment consultant could include addressing climate-related risks and opportunities material to the scheme and adopting the core service accordingly (including demonstrating a robust track-record that shows the adviser's capacity to assess and address the issues).

Strategy

- Identify, on an ongoing basis, climate-related risks and opportunities 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. The guidance will support trustees to understand and identify risks and opportunities by providing examples that trustees should consider and report on, such as the increased pricing of greenhouse gas emissions/carbon; substitution of existing products and services with lower emissions alternatives; successful investments in new technology; and litigation risk. Guidance will also help trustees assess risks and opportunities for individual scheme sections and different asset classes.

  In a DB Scheme this will involve considering the scheme's funding levels and employer covenant as part of an IRM approach. In a DC Scheme, trustees should consider the risk/return profile appropriate to the membership and in

particular the design of the default investment strategy.

Scenario analysis

- At least annually, as far as they are able, assess the resilience of the scheme's assets, liabilities and investment strategy and, in the case of DB schemes, funding strategy to climate-related risks in at least 2 climate-related scenarios, including at least one scenario that represents an eventual global average temperature rise of between 1.5 and 2°C from pre-industrial levels. The DWP recognises that such analysis is particularly challenging given the lack of data available. The Government does not propose to prescribe whether scenario analysis should be qualitative or quantitative. Guidance will set out what level of endeavour is expected of trustees and how to use the outputs of scenario analysis to inform their understanding.

  For DB schemes, scenario analysis should be used to assess the impact of different scenarios on sponsor covenant and funding levels as well as investment portfolios. For DC schemes, scenario analysis should focus on the effect of different warming and transition scenarios on members' pension pots.

Risk Management

- Adopt and maintain, on an ongoing basis, processes for identifying, assessing and managing climate-related risks, and ensure that climate-related risks are integrated into the scheme's overall risk management apparatus. Statutory guidance will set out factors that trustees should take into account when deciding how to prioritise the various risks they identify based on materiality, including likelihood and financial impact, and working with asset managers and others to ensure that identified risks are managed and addressed in the investment chain.

The PCRIG's draft guidance notes that the scale and complexity of climate change and its resulting impacts requires strong and well-defined risk management processes to ensure that the risks are being measured and managed. PCRIG suggest that trustees may consider a number of strategic actions to reduce identified exposure to risk, which might include a shift in passive investments to low carbon benchmarks rather than tracking a market-capitalisation weighted index.

Metrics

- Select at least one appropriate greenhouse gas emissions (GHG) based metric and at least one other non-emissions-based metric to assess scheme assets against climate-related risks and opportunities and review the selection on an ongoing basis. Data must be obtained on a quarterly basis to inform the targets that are set. The guidance will state that trustees should choose their Weighted Average Carbon Intensity (WACI) as their emissions-based metric.

  The proposal is to impose identical requirements on Scope 1 emissions (all direct emissions from the activities of the organisation), scope 2 emissions (indirect emissions from electricity purchase and used), and scope 3 emissions (all other indirect omissions from sources the organisation does not control, such as business travel and procurement, waste and water).

  The PCRIG's draft guidance contains more detailed explanations of the different metrics available and their advantages and potential drawbacks.

Targets

- At least annually, set at least one target to manage climate-related risks for one of the metrics, which can be an emissions-based metric or a non-emissions-based metric. Trustees will be required to measure performance against the target at least quarterly. Guidance will set out the matters

to which the trustees must have regard, including whether the target is "absolute" or "intensity" based; time frames over which the target applies; the base year from which progress is measured; and key performance indicators.

Several benchmarks are publicly available for many of the metrics. The MSCI produce a free directory of WACI for 20 indices.

TCFD Report

The annual TCFD report will have to include information about how the trustees have implemented the measures to identify, monitor and manage climate-related issues. Where trustees depart from the statutory guidance, they will need to explain the reasons for doing so.

Trustees will have to:

- Publish the TCFD report so it is accessible free of charge on a publicly available website.
- Reference the TCFD report in the scheme's annual report and accounts.
  - Tell members via their annual benefit statements (ABS) that the most recent TCFD report has been or will be published and where they can locate it. (The DWP proposes that, for DB schemes, this would apply only for members for whom they already are required to produce an ABS. For DC schemes, a weblink could direct members to a single page containing the TCFD report, the Chair's statement excerpts, SIP and Implementation Statement.)
- Provide the Pensions Regulator with the web address where they have published their TCFD report, via the annual scheme return. (The Regulations on registrable information would be amended to make this a mandatory requirement of the scheme return.)

The TCFD report will not have to be audited.

Penalties for non-compliance

The DWP proposes a mandatory penalty (minimum £2,500) only for wholesale non-compliance - i.e. failure to publish a TCFD report at all. Penalties for reports that TPR deems to be inadequate in meeting the requirements of the Regulations would 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 would be subject to the existing penalty regime in the Disclosure Regulations.

Next steps and related developments

The DWP's proposals are set out in its Consultation Paper, "*Taking action on climate risk: improving governance and reporting by occupational pension schemes*", which was published on 26 August 2020. The consultation closes on 7 October 2020.

The DWP's proposals are part of efforts by the UK Government, the pensions industry and other stakeholders to encourage businesses, asset managers, financial institutions and other economic actors to deepen their engagement with climate-related issues. For more details of other developments in this area see the following briefings that we have published:

- *PCAF publishes draft global carbon accounting standard for the financial sector*
- *Climate Financial Risk Forum publishes guidance for firms on climate-related risks and opportunities*
- *Disclosure of climate-related information by listed companies - FCA proposals*
- *All change, no change? Corporate reporting in the post-Brexit world*

If you would like further information about this topic, please speak to your usual Slaughter and May contact.

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APPENDIX

TCFD Recommendations

The TCFD is a global, private sector led group assembled in December 2015 at the instigation of the international Financial Stability Board (FSB). Following extensive public consultation, the TCFD published its recommended disclosures in June 2017.

The final report included four recommendations and 11 supporting recommended disclosures (together, the Recommendations), split into four categories: Governance, Strategy, Risk Management and Metrics and Targets:

GOVERNANCE Disclose the organisation's governance around climate-related risks and opportunities	STRATEGY Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material	RISK MANAGEMENT Disclose how the organisation identifies, assesses, and manages climate-related risks	METRICS AND TARGETS Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material
Recommended disclosures a) Describe the board's oversight of climate-related risks and opportunities. b) Describe management's role in assessing and managing climate-related risks and opportunities.	**Recommended disclosures** a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium, and long term. b) Describe the impact of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning. c) Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	**Recommended disclosures** a) Describe the organisation's processes for identifying and assessing climate-related risks. b) Describe the organisation's processes for managing climate-related risks. c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.	**Recommended disclosures** a) Disclose the metrics used by the organisation to assess climate-related risks and opportunities in line with its strategy and risk management process. b) Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks. c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.

The Recommendations are designed to provide a flexible framework for all organisations, including both the financial sector - from asset managers to asset owners and including banks, insurers and pension schemes - and non-financial groups, to produce decision-useful, forward-looking information on the financial impacts of climate change. They are also designed to accommodate future changes in climate-related modelling, management and reporting. The Government's expectation is that all listed companies and large asset owners will disclose in line with the TCFD Recommendations by 2022.

The DWP believes that TCFD-aligned disclosures would provide trustees with an opportunity to move away from the relatively high-level disclosures prescribed in the Statement of Investment Principles (the SIP), and permit them to demonstrate how the consideration of climate change risks and opportunities are integrated into the pension scheme's entire decision-making apparatus. Disclosing information provides greater transparency to beneficiaries about how their money is being managed.