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Climate change and pension investment: what should trustees be considering?

November 2020 Pension briefing

HIGHLIGHTS

The DWP is consulting on measures to ensure that trustees of large occupational pension schemes focus on the impact of climate change on their investments and (for defined benefit schemes) the employer covenant.

The requirements will initially apply only to the very largest schemes (schemes with assets worth £5 bn or more, plus authorised master trusts and collective defined contribution (CDC) schemes) but will later be extended – after a year to schemes with assets of £1 bn then, potentially, to all schemes.

While the new legal requirements will only apply, at least initially, to very large schemes, the risks and opportunities associated with climate change are arguably relevant to all occupational pension schemes.

This note considers:

- existing ESG/climate change requirements applicable to all occupational pension schemes; and
- the proposed new requirements, initially applicable only to very large schemes, master trusts and CDC schemes.

It also explains some of the important background developments in relation to climate-change risk and investment.

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INTRODUCTION

Climate change risks and opportunities are increasingly seen as factors which trustees of occupational pension schemes can and should take into account when investing their scheme assets. Trustees of both defined benefit (DB) and defined contribution (DC) schemes may experience the impact of climate change on the value of their scheme assets.

Trustees of DB schemes should also be alert to the impact of climate change on their sponsoring employer.

Types of risk

The TCFD (please see the Glossary) recognises two broad categories of climate change risk:

- **Transition risks**: associated with the realignment of business and society towards low-carbon and climate resilient solutions. This would include change brought about through regulation or encouraged through differential tax rates; and
- **Physical risks**: relating to the impact of climate change, such as increased flooding, changing rainfall and extreme weather events.

To achieve the objectives of the Paris Agreement (please see the Glossary), governments' policy and regulatory intervention may become more stringent. The Principles for Responsible Investment (PRI) calls this the "Inevitable Policy Response" and warns investors that current financial markets have not adequately priced in the likely impact of policy change in the near term.

Tighter regulation may in turn impact the value of assets in trustees' portfolios and the covenant of their sponsoring employers. Trustees should also be aware of the risk of being left holding obsolete or non-performing "stranded assets", whose value is significantly reduced.

Glossary

- **ESG** : environmental, social and governance factors
- **Paris Agreement**: an international commitment made in 2016 at the UN Framework Convention on Climate Change to hold the increase in global average temperature to "well below" 2° C above pre-industrial levels by 2100 and to pursue efforts to limit the increase to 1.5° C above pre-industrial levels.
- **PCRIG** : Pensions Climate Risk Industry Group, established in 2019 to develop guidance for pension schemes on the TCFD requirements (please see the box below).
- **PCRIG draft guidance** : PCRIG issued draft non-statutory guidance for consultation in March this year. While the new requirements under the Pension Schemes Bill only apply to very large schemes, authorised master

trusts and collective defined contribution schemes (please see Scope below), the draft guidance makes clear that trustees of all occupational schemes should take climate change risk into account.

- **TCFD** : Task Force on Climate-related Financial Disclosure (please see box below for details).
- **TEG** : Technical Expert Group on sustainable finance, set up by the European Commission in June 2018.

EXISTING CLIMATE CHANGE REQUIREMENTS

- Pension trustees already have a duty to consider factors which are financially material when making investment decisions. There is an increasing consensus that climate change is a financially material factor and is therefore something to which trustees should give serious consideration.
- Market thinking and practice on "green" or ESG investments and investment labelling is evolving. The UK and the EU are taking initiatives to provide clarity and consistency in this area (please see Background developments below).
- Under regulations in force on 13 January 2019, trustees must have an *"effective system of governance"*. The Pensions Regulator is required to issue a code of practice (still awaited) which must cover various aspects of this requirement, including how ESG factors are included in investment decisions.

Statement of investment principles (SIP)

- From 1 October 2019, the trustees' SIP must cover their policy in relation to *"financially material considerations"* over the appropriate time horizon of the investments, including how those considerations are taken into account in the selection, retention and realisation of investments.
- For this purpose, *"financially material considerations"*: includes (but is not limited to) ESG considerations (specifically including climate change), which the trustees consider financially material.

DC schemes and climate change

Trustees of DC schemes may decide it is appropriate to offer members the option of choosing a "green" fund as one or more of their self-select options. However, the PCRIG draft guidance recommends that trustees should consider the relevance of climate change when deciding on both the default fund and self-select funds for their members.

Reminder: climate change provision in the Pension Schemes Bill

The Pension Schemes Bill (currently before Parliament) will insert new sections 41A – 41C in the Pensions Act 1995. The new provisions contain regulation-making powers to require occupational pension scheme trustees to:

- secure effective governance with respect to the effects of climate change, especially:
  - risks from steps taken by governments and others in relation to climate change (for example, carbon reduction strategies); and
  - opportunities relating to climate change (for example, investment in industries developing cleaner technologies);
- review their scheme's exposure to prescribed risks and adopt a strategy to manage this exposure;
- assess their scheme assets in a prescribed manner, including the assets' exposure to prescribed risks and their contribution to climate change;
- adopt targets relating to exposure to prescribed risks and measure performance against those targets; and
- disclose information on the effects of climate change on their scheme in accordance with prescribed requirements.

When complying with the regulations, schemes must have regard to statutory guidance. The government is expected to consult on draft regulations and guidance in due course.

Trustee liability insurance and ESG / climate risks

Though not a legal requirement, we recommend that trustees review their trustee liability insurance to establish what cover is provided in relation to ESG or climate-related risks.

PROPOSED NEW REQUIREMENTS

Overview

Earlier this year, the government amended the Pension Schemes Bill to give itself power to impose new obligations on trustees in relation to climate change. For details, please see the box above.

Trustees of schemes within the scope of the new requirements in the Pension Schemes Bill (please see Scope below) must:

- have effective governance (comprising: strategy, scenario analysis, risk management, and accompanying metrics and targets) for the assessment and management of climate risks and opportunities from 1 October 2021; and
- make disclosures in line with the TCFD's recommendations within seven months of the end of the scheme year underway on 1 October 2021, or (if earlier) by 31 December 2022.

Investment decisions will however remain with trustees and the government makes clear there is no expectation that trustees will invest or disinvest in a particular way.

Trustees will initially be expected to comply with the new requirements *"as far as they are able"*, recognising there may be difficulties with obtaining some data.

The Pensions Regulator is expected to consider whether trustees who comply with the new climate change regulations may be deemed to have complied with climate change standards in the Regulator' forthcoming governance code.

Consultation and future developments

The new requirements are set out in a consultation paper issued by the DWP and are aimed at embedding the TCFD recommendations (please see Background developments below) into UK pension law. The consultation paper will be

followed by consultation on draft regulations and statutory guidance. The regulations are expected to be made in 2021.

The government also intends future consultation on mandatory reporting on the alignment of investment portfolios with the goals in the Paris Agreement.

Portfolio warming

- The DWP consultation points out that one way of understanding and reporting progress towards alignment with the Paris Agreement which has gained traction within the financial sector is the idea of measuring *"portfolio warming"* or the *"implied temperature rise"* (ITR) of investment portfolios.
- The DWP believes that undertaking the analysis to determine the ITR of their portfolios will help trustees to gain greater understanding of their associated climate risk and opportunities. For example, where a scheme's ITR is found to be 4°C, its trustees could see that it is likely to be significantly affected by public policy measures aimed at limiting the global average temperature increase to well below 2°C. Trustees could then use this information to better inform pension scheme strategy.
- For ITR to be an effective metric to assess risks and opportunities, a reliable and effective methodology (or methodologies) is needed. The DWP notes that at present the available methodologies for measuring ITR are not considered sufficient.
- However, the government expects that best practice in assessing ITR will develop over the next 12 months and intends to consult on alignment with the Paris Agreement and ITR in the near future. The future consultation may also consider other ways of measuring and reporting Paris alignment.

SCOPE AND TIMING OF NEW REQUIREMENTS

First schemes within scope

From 1 October 2021, the new requirements will apply to:

- authorised master trusts;
- authorised collective money purchase (CDC) schemes; and
- schemes with net assets of at least £5 bn.

For this purpose, the value of the scheme assets must be assessed at the first scheme year end on or after 1 June 2020 (and at subsequent year ends).

What about hybrid (DB and DC) schemes?

For schemes with hybrid benefits or more than one section, the total net assets of the scheme must be considered. Where the threshold is met, the requirements will apply to the whole scheme.

Can a scheme fall out of scope?

Once a scheme has been within scope, the requirements will continue to apply unless:

- it loses authorisation as a master trust or CDC scheme (where applicable); and
- its assets at the scheme year end are worth less than £500 million.

Extension to smaller occupational schemes

From 1 October 2022, the new requirements will also apply to schemes with net assets of at least £1 bn.

The new requirements will be reviewed in 2024, and may be rolled out further, potentially to all occupational pension schemes.

GOVERNANCE: DETAILS OF NEW REQUIREMENTS

Governance strategy

Trustees of schemes within scope will be expected to:

- identify and assess on an ongoing basis the climate-related risks and opportunities which will affect their scheme's investment strategy (and funding strategy, if DB) over the short, medium and long term; and
- disclose those risks and opportunities and their impact in a TCFD report.

The draft PCRIG guidance includes examples of risks and opportunities which trustees might consider, such as:

- increased pricing of greenhouse gas (GHG) emissions / carbon;
- substitution of cleaner alternatives;
- litigation risk; and
- extreme weather exposure.

Trustees should consider these factors at portfolio level but also for individual sections within the scheme, and for each popular DC default fund.

Scenario analysis

At least annually, trustees within scope will be expected to analyse two or more climate-related scenarios in relation to their scheme.

- One scenario must correspond to a global temperature rise of 1.5 - 2°C. Statutory guidance will set out other possible scenarios and how trustees may approach external factors such as data gaps.
- The analysis should consider the resilience of scheme assets, scheme liabilities and the trustees' strategies under different scenarios.
- For DB schemes, scenario analysis should include consideration of their sponsoring employer's covenant and how climate change may pose risks to this.

Risk management

Trustees within scope must adopt and maintain (on an ongoing basis) processes for identifying, assessing and managing climate-related risks.

- Climate-related risks must then be integrated into the trustees' overall risk management.
- Trustees must disclose their processes for managing climate-change risks (please see Disclosure below).
- Statutory guidance is expected to cover:
  - the types of processes trustees should adopt;

- materiality of risks; and
- working with others in the investment chain.

Metrics

Trustees within scope will be expected to:

- choose at least one emissions-based and one non-emissions based metric from a range in statutory guidance and use these metrics to assess their scheme assets against climate-related risks and opportunities;
- use weighted average carbon intensity (WACI) as their emissions-based metric, or explain why they have chosen a different metric;
- set and review the metrics they wish to analyse at least annually;
- obtain data on emissions and other characteristics of the scheme investments which they wish to quantify from their asset managers or direct from the investee companies. The consultation recognises that obtaining some data may be challenging, and so expects trustee to gather data *"as far as they are able"*; and
- calculate the chosen metrics at least quarterly.

The trustees' chosen metrics should quantify the effects of climate risks and opportunities on the scheme (or on the governance of those risks and opportunities).

Emissions-based and non-emission based metrics

Emissions-based metrics rely on disclosure of an organisation's Scope 1, 2 & 3 emissions:

- **Scope 1**: all direct emissions from an organisation's activities or under its control, for example gas boilers, fleet vehicles;
- **Scope 2**: indirect emissions from electricity purchases used by the organisation;
- **Scope 3**: all other indirect emissions from sources not directly controlled by the organisation, for example business travel, procurement, production of inputs, waste and water.

Examples of **non-emission metrics** include:

- how many investee firms have issued an emissions target;
- the percentage of the portfolio invested in green opportunities; and
- the level of engagement with investee companies.

Targets

Trustees within scope must:

- set at least one target for one of metrics they choose to publish;
- set the target(s) at least annually and measure performance against the target(s) at least quarterly as far as they are able; and
- disclose their targets and performance against those targets annually in their TCFD report.

Statutory guidance will set out various matters which trustees must take into account when setting a target, including:

- the base year from which progress is measured;
- key performance indicators used to assess progress against the target; and
- time frames over which the target applies.

DISCLOSURE: NEW REQUIREMENTS

Trustees of a scheme within scope will have to:

- issue a TCFD disclosure report in line with the TCFD recommendations, which are based on the four main areas of:
  - governance;
  - strategy;
  - risk management; and
  - metrics and targets.
- publish the TCFD report on a publicly available website;
- include a reference to the TCFD report in their annual report; and

notify members of their TCFD report via annual benefit statements). DB members who are not entitled to an annual benefit statement could be notified via the annual statutory funding statement. The TCFD has issued a detailed annex on implementing its recommendations and technical guidance on using scenario analysis.

TCFD principles for effective disclosure

The TCFD has developed a set of principles for effective disclosure:

- **Principle 1**: **present relevant information**: including sufficient detail to enable users to assess the organisation's exposure and approach to climate-related issues;
- **Principle 2**: **specific and complete disclosures**: containing historical and future-oriented information to allow users to evaluate their previous expectations relative to actual performance and assess future financial implications;
- **Principle 3**: **clear, balanced and understandable disclosures**, reporting at a level beyond compliance with minimum requirements;
- **Principle 4**: **consistency over time**: to enable users to understand the development of the impact of climate-related issues on the organisation, while explaining any changes in disclosures or formats used;
- **Principle 5**: **comparability within a sector, industry or portfolio**: to allow meaningful comparisons to be made;
- **Principle 6**: **reliable, verifiable and objective disclosures**: subject to internal governance processes substantially similar to those used for financial

reporting;

- **Principle 7: disclosure on a timely basis**: at least annually within the mainstream financial report, with timely updates where a climate related risk causes a disruptive event with a major financial impact.

NEW REQUIREMENTS: PENALTIES FOR NON-COMPLIANCE

A complete failure to publish a TCFD report will be subject to a mandatory penalty (of a minimum of £2,500).

Other breaches of the requirements may be subject to penalties at the Pensions Regulator's discretion (likely to be a maximum civil penalty of £50,000 for corporates and £5,000 for individuals).

BACKGROUND DEVELOPMENTS

UK Green Finance Strategy

In July 2019, the UK government launched its Green Finance Strategy. The goals set out in the Strategy include the following:

- expecting all listed companies and large asset owners to disclose in line with the TCFD recommendations (please see below) by 2022;
- working with regulators, including the Pensions Regulator, recognising the importance of climate-related financial factors to the regulators' work;
- supporting developments such as the Transition Pathway Initiative tool, which helps asset owners assess companies' preparedness for the transition to a low carbon economy; and
- funding the British Standards Institution (BSI) to develop sustainable finance Publicly Available Specifications (PASs), including PAS 7341 on Sustainable Investment Management and a PAS currently under development on sustainable financial products and funds.

The Climate Change Act 2008 put in place a framework for achieving an 80% reduction in the UK's carbon emissions by 2050. The UK government has since adopted a new target to reach net zero greenhouse gas emissions by 2050.

Task Force on Climate-related Financial Disclosures (TCFD)

The TCFD is a global, private sector led group assembled in December 2015, supported by Mark Carney and chaired by Michael Bloomberg. Its aim was to develop voluntary, consistent climate related financial risk disclosures for companies to use when providing information to investors, insurers, lenders and other stakeholders.

In June 2017 the TCFD published recommended disclosures, intended for use by non-financial groups and the financial sector, including asset managers and owners (for example: banks, insurers and pension schemes).

The TCFD made 11 recommendations for disclosures, divided into four sections: governance; strategy; risk management; metrics and targets.

The UK formally endorsed the TCFD recommendations in September 2017.

EU Sustainable Finance Action Plan (SFAP)

The European Commission published the SFAP in March 2018, and has instituted a package of reforms aimed at integrating ESG considerations consistently across financial sectors. There are three key European regulations:

- **The Disclosure Regulation 2019/2088**: imposes new sustainability disclosure requirements on financial market participants, including occupational pension schemes. (The requirements of this regulation have effect from 10 March 2021 but, at the time of writing, are not expected to apply within the UK.)
- **The Low Carbon Benchmark Regulation 2019/2089**: sets minimum requirements for climate-change benchmarks. In September 2019, the TEG (please see the Glossary) created two new types of benchmarks:
  - EU Climate Transition Benchmarks (CTB); and
  - EU Paris-Aligned Benchmarks (PAB).
- **EU Taxonomy Regulation 2020/852**: intended to help investors and others by creating a unified classification system ("taxonomy") of environmentally sustainable economic activities. In particular, it sets EU-wide performance thresholds (known as "technical screening criteria") for economic activities which:
  - make a substantive contribution to one of six environmental objectives;
  - do no significant harm to the other five objectives (where relevant); and
  - meet minimum safeguards (such as the UN Guiding Principles on Business and Human Rights).

The European Commission is also working to develop an EU Green Bond Standard .

International Organisation for Standardisation (ISO)

The ISO has established a new Technical Committee on Sustainable Finance, chaired by the UK, and aimed at integrating sustainability considerations and ESG practices into institutional investment decision making and finance management. The committee is currently developing a Framework for sustainable finance: Principles and guidance (ISO/WD 32210).

RESOURCES

- British Standards Institution (BSI)
- DWP consultation "Taking action on climate risk: improving governance and reporting by occupational pension schemes
- DWP TCFD for pension scheme trustees: quick start guide
- PCRIG draft guidance
- Principles for Responsible Investment (PRI) /
- TCFD materials
- Transition Pathway Initiative
- UK Green Finance Strategy

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