LCP briefing note

23 June 2022

Climate risk for pensions – new regime for large schemes

At a glance

Climate governance and reporting requirements are now in force for the largest occupational pension schemes in the UK. There is primary legislation, secondary legislation, statutory government guidance, Pensions Regulator guidance and non-statutory guidance from the Pensions Climate Risk Industry Group. Together these make for an extensive and prescriptive regime which this briefing note summarises.

Key actions for trustees

- **For all schemes,** familiarise yourself with the DWP's requirements
- **If your relevant scheme assets exceed £5bn, or if you are an authorised master trust or intend to be a collective money purchase scheme**, continue to implement a compliant system of climate governance and prepare for your first public report
- **If your relevant scheme assets exceed £1bn**, implement a compliant system of climate governance by 1 October 2022
- **If your relevant scheme assets are less than £1bn**, ensure you are managing climate-related risks and opportunities for your scheme – do not make the mistake of thinking that this is only for very large schemes; climate requirements will likely apply to you in a few years

The Detail

There are two broad sets of requirements – governance (including strategy, risk management, scenario analysis, metrics and targets) and reporting.

DWP has implemented the climate requirements for large schemes that were introduced by the Pension Schemes Act 2021 through regulations and statutory guidance.

Key documents

The legal basis for the new regime is the Pension Schemes Act 2021 which inserts new climate provisions into the Pensions Act 1995, supported by regulations and statutory guidance.

The detailed legal requirements are set out in three pieces of secondary legislation: the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (SI 2021/839), the Occupational Pension Schemes (Climate Change Governance and Reporting) (Miscellaneous Provisions and Amendments Regulations 2021 (SI 2021/857) and the Occupational Pension Schemes (Climate Change Governance and Reporting) (Amendment, Modification and Transitional Provision) Regulations 2022[1] (the Regulations).

The Department for Work and Pensions (DWP) has published statutory guidance which came into force from 1 October 2021, to which trustees in scope of the Regulations must have regard, with an amended version (published on 17 June 2022) due to come into effect on 1 October 2022. This note reflects this updated set of requirements.

In January 2021, the DWP published finalised non-statutory guidance which was prepared by the cross-government and industry group: the Pensions Climate Risk Industry Group (PCRIG). This non-statutory guidance is intended to assist trustees of all schemes in meeting their obligations to manage climate-related risks.

On 16 December 2021, the Pensions Regulator published guidance to assist trustees in implementing the legal requirements, as well as an appendix to its monetary penalties policy which explains the enforcement approach it may take. On 23 February 2022, the Regulator published an appendix to its guidance with a step-by-step example illustrating the entire process of implementing the new climate regime from start to finish.

The Regulator has also provided guidance.

Our viewpoint

At a high level we fully support the DWP's package of regulations and guidance, which we believe is necessary to help steward the UK economy towards meeting the goals of the 2015 Paris Agreement on climate change.

The speed at which the DWP has implemented the new climate regime demonstrates that the Government is treating this systemic financial risk with the seriousness it deserves

Timing

The new requirements are being imposed in two waves initially. Schemes with *"relevant assets"* equal to or more than £5bn, together with authorised master trusts and collective

[1] The last of these is still subject to Parliamentary approval.

money purchase schemes, are the first wave. Schemes with relevant assets equal to or more than £1bn are the second wave.

DWP will hold an interim review of the new requirements in the second half of 2023, based on which they will consider whether to extend them to smaller pension schemes.

Relevant assets are defined as the total of the net assets shown in the audited accounts for the scheme year less the value of any "*relevant insurance contracts*" shown in those accounts – broadly buy-ins (bulk annuities) and insured pensions (individual annuities secured from money purchase funds).

The requirements come into force as follows:

- Schemes with relevant assets equal to or more than £5 billion on the first scheme year end date which falls on or after 1 March 2020 must comply by 1 October 2021[2].
- Authorised master trusts and collective money purchase schemes must comply by 1 October 2021.
- Schemes with relevant assets equal to or more than £1 billion on the first scheme year end date which falls on or after 1 March 2021 must comply by 1 October 2022[1].

The requirements apply to schemes with relevant assets of £5bn+ from 1 October 2021, and £1bn+ a year later.

There are provisions for additional schemes to be brought into scope if their relevant assets subsequently reach the £1bn threshold or they receive authorisation. Broadly speaking, once the asset test has been met by a scheme, the requirements continue to apply to it until relevant assets fall below £500m at a future scheme year-end.

A key part of the new climate requirements is the preparation of a climate report in line with the recommendations of the Task force on Climate-related Financial Disclosures, ***the TCFD report***. This report must be produced and published online within seven months of the scheme year end for any scheme year in which the scheme is required to comply with the requirements above.

Level of the assessment

The statutory guidance states that the ***governance*** and ***risk management*** activities should be carried out for the whole scheme, whereas the ***strategy, scenario analysis*** and ***metrics*** activities should be carried out at the following levels:

[2] Or the date on which the trustees obtain audited accounts in relation to that year end if later.

- For a single section DB scheme, or for a DC scheme with no member choices: whole scheme.
- For a scheme with more than one DB "section" (whether or not formally segregated): each section, except that sections with similar characteristics in relation to assets, liabilities and funding may be grouped together.
- For DC schemes: for each popular "arrangement" offered by the scheme, where a popular arrangement is one with £100m invested or which accounts for 10% or more of the scheme's money purchase assets.

Governance

The over-arching requirement is that trustees must establish and maintain oversight of the climate-related risks and opportunities which are relevant to their scheme.

Trustees should develop an appropriate climate governance structure for their scheme, with roles and responsibilities allocated to the main trustee board, sub-committees and individual trustees as appropriate, although the guidance indicates that they have a wide degree of latitude in how they do this.

Trustees must have an appropriate governance structure to oversee relevant climate-related risks and opportunities backed-up by appropriate knowledge and understanding.

Where governance activities are delegated to a third party, or where a (non-legal) adviser advises on those activities, the trustees must establish and maintain processes for satisfying themselves that the third party/adviser takes adequate steps to identify, assess and manage climate-related risks and opportunities which are relevant to the governance activities they are undertaking.

Where the governance requirements apply, the existing requirements for trustee knowledge and understanding are expanded to include principles relating to the identification, assessment and management of climate-related risks and opportunities for occupational pension schemes. The guidance sets out further detail. So, for example, trustees will be expected to understand how scenario analysis works (although not necessarily to have command of the technical detail), why climate change poses a material financial risk and its relevance to overall risk management.

Our viewpoint

The statutory guidance describes in detail how trustees are expected to embed climate change throughout their governance structures and processes. It implies a significant allocation of time and resource, which may pose challenges for trustees who need to balance climate change with the many other topics competing for their attention.

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Strategy and scenario analysis

The Regulations require trustees, on an ongoing basis, to ***identify*** and to ***assess the impact*** of climate-related risks and opportunities which they consider will have an effect over the short term, medium term and long term (with the trustees to define these time periods themselves) on the scheme's investment strategy and, if applicable, funding strategy. The statutory guidance clarifies that, in relation to funding strategy, trustees should consider the strength of the covenant offered by the sponsoring employer.

Trustees must, as far as they are able, undertake scenario analysis in at least two scenarios where there is an increase in the global average temperature. In one of those scenarios, the global average temperature increase must be within the range of 1.5 to 2 degrees Celsius above pre-industrial levels. The analysis must consider for each scenario:

Trustees must analyse the potential impact of at least two climate scenarios on their scheme, at least once every three years.

- the potential impact on the scheme's assets and liabilities of the effects of the global average increase in temperature and of any steps which might be taken (by governments or otherwise) because of the increase in temperature;
- the resilience of the scheme's investment strategy; and
- where the scheme has a funding strategy, the resilience of the funding strategy.

The required scenario analysis must be undertaken at least once every three years, including in the first scheme year in respect of which the governance and other requirements apply.

In scheme years where the trustees are not required to undertake scenario analysis, the trustees must review the most recent scenario analysis they have undertaken and determine whether it is nevertheless appropriate to undertake new scenario analysis. For example, this might be due to a material change in investment strategy, improvements in the scenarios available, or significant new global policy commitments. If new analysis is undertaken, the three-yearly cycle re-sets.

Our viewpoint

Scenario analysis is arguably the most complex and technical of the TCFD recommendations, so the "as far as they are able" wording is helpful. The requirement to undertake the analysis triennially (rather than annually as originally proposed) reduces the burden, although – given the rapid pace at which climate policy and modelling is developing – we suspect many trustees will find themselves concluding that more frequent analysis is appropriate.

Risk management

Trustees must establish and maintain processes for the purpose of enabling them to identify, assess and effectively manage climate-related risks which are relevant to the scheme.

Climate-related risks must be integrated into overall risk management.

Trustees must ensure that management of climate-related risks is integrated into their overall risk management of the scheme.

Metrics and targets

A key aspect of the regime is that trustees must select at least four[3] "metrics" – ie climate-related measurements – to calculate and report for their scheme's assets (although see next section), including:

Trustees must calculate at least four climate-related metrics for their assets, at least annually.

- one "absolute emissions metric": the total greenhouse gas (GHG) emissions associated with the scheme's assets;
- one "emissions intensity metric": for example, the total GHG emissions per £m invested by the scheme;
- one "portfolio alignment metric": for example, the percentage of investments in the portfolio with declared net zero or Paris-aligned targets; and
- one "additional climate change metric": for example, climate value at risk[4], data quality[5], proportion of assets materially exposed to climate-related physical risks, proportion of assets materially exposed to climate-related transition risks, proportion of assets aligned toward climate-related opportunities, or amount of expenditure or capital investment deployed toward climate risks and opportunities.

Trustees must review their selection of metrics from time to time as appropriate to the scheme. Once trustees have calculated their selected metrics, they must use them to identify and assess the climate-related risks and opportunities which are relevant to the scheme.

To calculate their metrics, trustees must, for each scheme year and as far as they are able, obtain the following GHG emissions data for all of the scheme's assets (including buy-in contracts):

[3] Three for scheme years ending before 1 October 2022, with use of a portfolio alignment metric being optional and fewer recommended options for the additional climate change metric.

[4] This metric aims to measure the size of the loss attributable to climate-related risks a portfolio may experience, within a given time horizon, if a particular scenario unfolds.

[5] This metric aims to measure the proportion of the portfolio for which the trustees have high quality GHG emissions data.

- **Scope 1** emissions – all direct GHG emissions from the activities of an entity or under its control;
- **Scope 2** emissions – all indirect GHG emissions created during the production of electricity which the entity purchases and uses;
- **Scope 3** emissions – all indirect GHG emissions from activities of the entity, other than Scope 2 emissions, which occur from sources that the entity does not directly control.

Trustees do not have to collect and report on Scope 3 emissions in the first scheme year that they are subject to the requirements.

Trustees must set a target in relation to at least one of their selected metrics, for some or all of their assets. In each scheme year, they must measure, as far as they are able, the performance of the scheme against this target and, taking into account the scheme's performance, determine whether the target should be retained or replaced. The statutory guidance clarifies that the target is not legally binding and should not conflict with trustees' fiduciary duties.

In each scheme year trustees must set at least one climate-related target and measure performance against it.

Our viewpoint

Metrics is another challenging area given that there are significant gaps in the data available, particularly for asset classes other than listed equities and corporate bonds. Fortunately, various initiatives are underway to improve the data available, and in the meantime trustees need not take steps beyond those that are reasonable and proportionate.

TCFD report

A key element of the regime is the publication of an annual report containing the information recommended by the Task force on Climate-Related Disclosures (TCFD). The report must relate to the previous scheme year and be published within seven months of the scheme year-end. Where the scheme was only subject to the climate requirements for part of a scheme year, the trustees need only report on that part-year.

Trustees' annual TCFD reports must be published online and notified to members.

The report must be published on a publicly available website, free of charge. The Disclosure Regulations have been amended so that trustees must provide the website address of their published TCFD report in their Annual Report. They must also include the address in members' annual benefit statements (where these are required), the annual funding statement for DB schemes and the annual Scheme Return to the Pensions Regulator.

The Regulations prescribe that the following must be included in the report:

Governance

- how the trustees maintain oversight of climate-related risks and opportunities which are relevant to the scheme;
- the role of any person apart from a trustee who undertakes scheme governance activities in identifying, assessing and managing any climate-related risks and opportunities which are relevant to those governance activities, and the process by which the trustees satisfy themselves that the person is taking adequate steps to identify, assess and manage the climate risks and opportunities;
- the role of any person apart from a legal adviser who advises or assists the trustees with respect to scheme governance activities and the process by which the trustees satisfy themselves that the person is taking adequate steps to identify and assess any climate-related risks and opportunities which are relevant to the matters in respect of which they are advising or assisting;

Strategy

- the climate-related risks and opportunities which the trustees have identified as relevant to the scheme over the short, medium and long term;
- the time periods which the trustees have determined should comprise the short term, medium term and long term;
- the impact of the assessed climate-related risks and opportunities on the scheme's investment strategy and, where applicable, on the funding strategy;

Scenario analysis

- the most recent scenarios which the trustees have analysed;
- the potential impacts on the scheme's assets and liabilities which the trustees have identified in these scenarios and, if they have been unable to obtain data to identify potential impacts for all of the scheme's assets, why this is the case;
- the resilience of the scheme's investment strategy and, where applicable, the funding strategy in these scenarios;
- in years where trustees are not required to, and have determined that it is not necessary to undertake new scenario analysis, the trustees' reasons for this determination;

Risk management

- the processes which the trustees have established for identifying, assessing and managing climate-related risks which are relevant to the scheme;
- how these processes are integrated into the trustees' overall risk management of the scheme;

Metrics and targets

- the climate-related metrics which the trustees have calculated and, if the trustees have not been able to obtain data to calculate the metrics for all of the scheme's assets, why this is the case;
- the target which the trustees have set against one of these metrics and the performance of the scheme against the target.

The report must be signed by the chair of the trustees (although, helpfully, the trustees are not required to publish the manuscript signature).

Further details of the expected content of the report are set out in the statutory guidance.

Our viewpoint

The extensive list of disclosure requirements mirrors the actions that trustees are required to take under the various headings and is intended to provide transparency on the trustees' actions – a strong incentive for trustees to be thorough and rigorous in taking these actions. The presentation of the information will need careful consideration to ensure it can be understood by reasonably engaged and informed members, as the DWP wants.

The Pensions Regulator's guidance

In December 2021, the Regulator published "guidance on governance and reporting of climate-related risks and opportunities" to help trustees comply with the new requirements. In deciding whether schemes have complied, the Regulator proposes to look for clear evidence that trustees:

The Regulator has published guidance to help trustees comply with the new climate requirements.

- are taking proper account of climate change when making decisions and that advisers are helping them to do this;
- have carried out analysis in a way that is consistent with the TCFD recommendations so that savers and others can be confident in it;
- have seriously considered the risks and opportunities that climate change will bring to their scheme, in its particular circumstances; and
- have decided what to do as a result of this analysis and have set a target to help achieve that goal.

Each section of the guidance contains links to the corresponding sections of the statutory guidance, sets out "example steps to take", some worked examples and concludes with what must and should be disclosed in the TCFD report. The Regulator has said the guidance is not intended to impose any additional requirements on trustees.

Our viewpoint

Given DWP's extensive statutory guidance, trustees will be relieved that the Regulator's guidance sets few new expectations. Instead it provides lots of examples to help them understand this extensive body of law and regulation. Climate change is a new, complex and challenging topic for trustees to get to grips with, so we welcome the Regulator's supportive approach.

Complying with the new regime

The legal basis of the regime is the Regulations. However, the primary legislation under which the Regulations are made requires trustees *to "have regard to"* the statutory guidance which is itself framed in terms of *"must"*, "*should"* and *"may"*, with trustees expected to report their reasons for any significant divergences from the "should" guidance.

A new concept in pensions law/regulation is introduced: *"as far as they are able"*. In areas such as scenario analysis, data gathering, metric calculation and target measuring, trustees need only take all such steps as are reasonable and proportionate in the particular circumstances taking into account the costs, or likely costs, which will be incurred by scheme and the time required to be spent by the trustees or people acting on their behalf. Otherwise, there is an escalating system of compliance notices and penalty notices to enforce compliance.

Several requirements need only be implemented "as far as trustees are able".

On 16 December 2021 the Pensions Regulator published its final policy on levying penalties for non-compliance, in the form of Appendix 3 to its existing monetary penalties policy.

The legislation *requires* the Regulator to impose a penalty on trustees if they fail to publish their TCFD report free online within the required timeframe. The minimum penalty is £2,500. The maximum is £5,000 for an individual and £50,000 for corporates.

The Regulator is required to levy a fine of at least £2,500 for failure to publish a TCFD report.

The Regulator' policy on the mandatory penalties is that:

- All schemes receive the minimum penalty of £2,500;
- Any penalty for a further/repeated breach will normally be at least £5,000;
- Where the scheme has a professional trustee in place the minimum penalty will generally be £5,000 as the Regulator expects higher standards from them.

The Regulator also has discretion to impose penalties for other breaches of the climate regulations. In deciding the level of penalties, it will look at breaches in three bands as indicated in the table below:

Band	Example	Type of person	Range (£)
1	Failure by the chair to sign the climate change report	Individual	0 – 1,000
		Any other case	0 – 10,000
2	Failure to disclose scheme resilience in the scenarios analysed, but there is no underlying breach	Individual	0 – 2,500
		Any other case	0 – 25,000
3	Failure to identify and assess the impact of climate-related risks and opportunities on investment strategy	Individual	0 – 5,000
		Any other case	0 – 50,000

Our viewpoint

The monetary penalties appendix provides useful insights into the Pensions Regulator's intended enforcement approach, providing reassurance that it intends to be proportionate and take into account the nature and impact of the breach. How stringently it will be able to police the new regime given its severe resource constraints remains to be seen.

Next steps

The Pensions Regulator has consulted on a new single code of practice which will include modules on climate change and stewardship (the latter being an important tool for managing climate-related risks). The draft code, which we expect to come into force Autumn 2022, includes expectations that trustees of occupational pension schemes with 100 members or more:

Further regulatory expectations in relation to climate change will be included in the new single code of practice.

- consider the possible short, medium and long-term effects of climate change on the objectives of the scheme and its operations;
- maintain and document processes for identifying and assessing climate-related risks and opportunities;
- integrate these processes into their risk management and governance arrangements; and
- ensure the governing body oversees, assesses and manages climate-related risks and opportunities related to the scheme.

The Regulator is due to consult on changes to its covenant guidance in 2022, to incorporate more detail on what schemes should do to reflect climate-related risks and opportunities when assessing the strength of sponsor covenant. The Regulator also plans to signpost examples of best practice TCFD reporting in the future.

Our viewpoint

The new climate regime is now in force, requiring larger schemes to implement effective processes to manage climate-related risks and opportunities to their scheme. For many, this is requiring extensive effort as they address an important area of systemic risk that has historically not received the attention it deserves. As their new processes bed in, trustees will find it gets easier and they can take comfort that their members' pensions should be more secure as a result.

Smaller schemes should ensure they are addressing climate risk appropriately and familiarise themselves with the new requirements in preparation for a likely third wave.

This briefing note does not constitute advice, nor should it be taken as an authoritative statement of the law. If you would like any assistance or further information on the contents of this News Alert, please contact the partner who normally advises you at LCP on +44 (0)20 7439 2266 or by email enquiries@lcp.uk.com.

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