News Alert 2021/01

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Climate risk for pensions – new regime from this October

At a glance

We now have a high degree of certainty regarding the Government's policy on climate risk for pension schemes. We have primary legislation, draft regulations, draft statutory guidance and final non-statutory guidance and we know when the requirements will apply to which schemes.

The new requirements set out in this News Alert are extensive and highly prescriptive; the timescales, by the Government's own admission, are challenging.

Key actions for trustees

- **For all schemes,** familiarise yourself with the DWP's latest proposals and the final guidance from PCRIG
- **If your 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; prescribed climate requirements will likely apply to you in a few years
- **If your scheme assets exceed £1bn**, implement a compliant system of climate governance by 1 October 2022
- **If your scheme assets exceed £5bn, or if you are an authorised master trust or intend to be a collective defined contribution scheme**, implement a compliant system of climate governance by 1 October 2021

The Detail

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

The DWP is now consulting on the technical details of the climate requirements for large schemes that will be introduced by the Pension Schemes Act 2021.

The legal basis for the new regime is the soon-to-be Pension Schemes Act 2021 which inserts new climate provisions into the Pensions Act 1995. This will be supported by regulations and statutory guidance which the Department for Work and Pensions is now consulting on through the package of documents published on 27 January 2021. These include the response to DWP's August 2020 consultation, two sets of draft regulations made under the Act which will establish the new requirements and draft statutory guidance (which trustees of schemes in scope will be legally required to have regard to).

It is important to note that the regulations and the statutory guidance are out for consultation until 10 March 2021 so some of the detail set out in this News Alert may change before the new regime comes into force. We do not expect the broad outline or key timings to change.

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

Our viewpoint

At a high level we fully support the DWP's proposals, which we believe are 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 developed its proposals since the climate-related amendments were made to the Pension Schemes Bill in February 2020 demonstrates that the Government is treating this systemic financial risk with the seriousness it deserves. The headline changes that DWP has made in response to last year's consultation have struck an appropriate balance between addressing the practical concerns that we and others had identified and setting suitably high expectations for trustees' climate action.

Timing

As indicated in the August 2020 consultation, the new requirements will be imposed in two waves initially. Schemes with *"relevant assets"* equal to or more than £5bn together with authorised master trusts and collective 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 from late 2024 or early 2025.

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 ***governance, strategy, risk management and metrics and targets*** 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[1].
- 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 will apply to schemes with assets of £5bn+ from 1 October 2021, and £1bn+ a year later, as expected (although details and timing of the asset test have been tweaked).

The required ***scenario analysis*** must be undertaken in the first scheme year in respect of which the governance and other requirements apply and every three years thereafter, subject to an annual review.

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 in any scheme year in which the scheme is required to comply with the requirements above.

Our viewpoint

In a welcome move, the DWP has listened to feedback and relaxed the timing around the publication of the first TCFD reports. The backstops of 31 December 2022 for the first wave and 31 December 2023 for the second wave have been removed. Whereas previously a scheme with a 30 September year-end would have had just three months to publish its first report, it will now get a full seven months (aligned with the timetable for preparing its scheme accounts).

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

The DWP has also clarified that buy-ins are excluded when applying the asset test, meaning some trustees can breathe a sigh of relief that the prescribed climate requirements won't apply to their scheme (for now). However, we think it likely that the requirements will be extended to smaller schemes following the 2023 review, so all trustees should take note of the Government's expectations in this area.

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 draft 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 scheme.

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 draft guidance sets out further detail. So, for example, trustees will be expected to understand how scenario analysis works (although not 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 draft 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.

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 horizons themselves) on the scheme's investment strategy and, if applicable, funding strategy.

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 in the first scheme year in respect of which the governance and other requirements apply and every three years thereafter.

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.

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 in theory, 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 required.

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 three "metrics" – ie climate-related measurements – to calculate and report for their scheme, including:

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

- one "absolute emissions metric" (expected to be the total greenhouse gas (GHG) emissions associated with the scheme's assets);
- one "emissions intensity metric" (expected to be the total GHG emissions per £m invested by the scheme); and
- one "additional climate change metric" (not directly relating to GHG emissions).

Trustees must review their selection of metrics from time to time as appropriate to the scheme.

To calculate their metrics, trustees must, on an annual basis and as far as they are able, obtain the following GHG emissions data for the scheme's assets:

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

Once trustees have obtained the necessary data to calculate their selected metrics, they must use the metrics to identify and assess the climate-related risks and opportunities which are relevant to the scheme.

Trustees must set a target for the scheme in relation to at least one of their selected metrics. On an annual basis, 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.

Trustees must set at least one climate-related target and measure performance against it at least annually.

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.

The detailed requirements have changed since the August consultation – there is now a minimum of three metrics rather than two, with metric calculation and *target monitoring required annually rather than quarterly – and we suspect there may be further changes to the details in the final guidance, so this is an area to watch.*

TCFD report

A key element of the new regime is the publication of an annual report containing the information recommended by the Task force on Climate-Related Disclosures (TCFD).

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 are to be 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 who undertakes, or (non-lawyer) who advises or assists with, governance activities in relation to the scheme, in identifying, assessing and managing climate-related risks and opportunities relevant to the scheme; and
- the process by which the trustees satisfy themselves that the person is undertaking, advising or assisting such identification, assessment and management adequately;

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 climate-related risks and opportunities specified above 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;
- 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 to the scheme;
- how these processes are integrated within 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 assets of the scheme, why this is the case;
- the target(s) which the trustees have set against the metric(s) selected and the performance of the scheme against the target(s).

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

Our viewpoint

The extensive list of disclosure requirements mirror the actions that trustees are required to take under the various headings and are 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.

How compliance will work

There are elaborate mechanisms for policing 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 required to report their reasons for any significant divergences from the "should" guidance.

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

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, apart from where trustees fail to publish the TCFD report online, in which case there is a mandatory fine, there is an escalating system of compliance notices and penalty notices to enforce compliance.

Our viewpoint

How stringently the Pensions Regulator will be able to police the new regime given its severe resource constraints remains to be seen. But we have no doubt about Brighton's enthusiasm for the task.

Next steps

Consultation closes on 10 March 2021, with final regulations and statutory guidance due later in the year. LCP will be responding to the consultation. As noted at the start, we are supportive of the Government's proposals and in our response will be focusing on ensuring the proposals are practical and effective for our clients and the pensions industry.

Our viewpoint

Although the fine details are subject to change, the shape of the new climate risk regime is clear as are the timescales for complying. All schemes in the first and second waves can now move forward with confidence in ensuring they are on track to comply by the relevant date. Smaller schemes should ensure they are addressing climate risk appropriately and familiarise themselves with the new requirements in preparation for a likely third wave.

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