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Climate Change and Responsible Investment Team
Department for Work & Pensions
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Sent via email: pensions.governance@dwp.gov.uk

Dear Sirs

Taking action on climate risk: improving governance and reporting by occupational pension schemes

I am pleased to enclose our response to the above public consultation, which requested views on draft regulations and statutory guidance for new climate change governance and reporting requirements for occupational pension schemes.

We welcome the action being taken by Government in response to climate risk. Deloitte is committed to contributing positively to improved climate outcomes.

However, it is our view that the regulations and guidance as drafted could have unintended consequences for the consolidation of defined benefit ("DB") pension schemes. This could reduce the number of members, trustees and employers able to benefit from the reductions in costs and improved governance which consolidation can offer.

We are aware that Government has been seeking to encourage DB consolidation, and believe that updating the draft climate risk regulations and guidance could clarify the application of the new requirements so that the regulations achieve their intended outcomes without negatively impacting consolidation.

We set out below the reasons why the regulations and guidance could have unintended consequences, and how this could be addressed.

About Deloitte Pensions Services Limited

This response is sent on behalf of Deloitte Pensions Services Limited, as provider of the Deloitte Pensions Master Plan.

The Deloitte Pensions Master Plan is a sectionalised occupational DB pension scheme for non-associated employers. It is a DB master trust consolidation vehicle designed to bring the benefits of reduced costs and improved governance to DB pension schemes.

For the avoidance of doubt, the Deloitte Pensions Master Plan is not a DB superfund, and seeks to maintain the employers' responsibilities ("employer covenant") to schemes that choose to join.

Government encouragement of DB consolidation

In December 2018, the Government's public consultation "Consolidation of Defined Benefit Pension Schemes" sought views on a number of measures to support consolidation. Much of the 2018 consultation concerned superfunds where, for schemes that join, the employer covenant would be replaced by a capital buffer provided by investors.

Our response to this climate risk consultation does not consider superfunds. We note that Government intends to consult on additional requirements for authorised superfunds to undertake climate change governance and reporting in due course.

Aside from superfunds, the 2018 consultation noted that other forms of consolidation such as DB master trusts are already operational in the pension market – and that the Government wants to do more to help encourage existing forms of consolidation recognising the benefits it can bring in reducing costs per member, enabling more effective investment strategies and improving governance.

We understand that Government would not wish to unnecessarily hinder existing non-superfund consolidation options for DB schemes, nor the development of further similar options by market participants.

However, we believe that the regulations and guidance as currently drafted could have unintended consequences for such arrangements. Amending the regulations and guidance could avoid a negative impact for consolidation, while allowing the Government to achieve its intended aims for the climate risk requirements.

The climate change requirements exclude small and medium-sized DB schemes

Small and medium sized schemes are those with most to benefit from DB consolidation. Such schemes are also excluded from the current phased introduction of the climate change requirements.

The Government's intention for which DB schemes the requirements will apply to are, in summary, as follows:

- schemes with more than £5 billion of assets (and certain other schemes) will need to comply with the requirements from 1 October 2021
- schemes with more than £1 billion of assets will need to comply from 1 October 2022.

The consultation document comments that:

- where there are significant new costs, these would typically not constitute a significant proportion of governance spend for larger schemes

- the amount of a scheme's governance budget used for assessing climate risk would be proportionate for larger schemes, where the loss avoided or reduction in risk which would follow could, with a reasonably high degree of confidence, exceed the costs

- Government does not intend to introduce the requirements for schemes with assets below £1 billion at this stage and until services become more standardised and there is a clearer view on the extent to which associated costs would fall.

We agree that it is appropriate for small and medium-sized schemes below £1 billion of assets to be excluded from the requirements.

Application of the requirements for sectionalised DB schemes

Sectionalised DB schemes are the most common vehicles for existing forms of DB consolidation, because in a sectionalised scheme it can be possible to avoid the "cross-contamination" of one section's liabilities and deficit with those of other sections relating to other non-associated employers.

How the requirements apply to sectionalised schemes therefore impacts how the requirements might impact DB consolidation generally.

The consultation document states that it is intended:

- the £1 billion threshold is intended to apply at scheme level rather than section level

- duties fall on the trustees of the scheme rather than any governance committee appointed to manage a particular section

- trustees may wish to engage with the governance bodies of underlying sections to obtain data, share reports and consider associated reporting and changes to investment approach "in the usual way".

The draft guidance states that:

- governance and risk management activities should be carried out for the whole scheme

- trustees should undertake strategy activities, including scenario analysis, at section level rather than scheme level – although sections with similar characteristics in relation to assets, liabilities and funding may be grouped

- the calculation and reporting of metrics should be carried out similarly at section level, although trustees may choose not to aggregate data across certain asset classes within a given section if they believe it is not meaningful to do so.

We can see that the above proposals might be appropriate in the scenario which the consultation document seems to envisage: that a sectionalised DB scheme has a central scheme trustee which has some or all of the responsibility for decision-making around funding and investment strategy, perhaps assisted by governance committees at section level.

However, there is considerable flexibility in legislation around how schemes can be arranged, and not all sectionalised schemes are set up in the way envisaged in the consultation document's description. We believe the current regulations and guidance might have unintended consequences, because it is not clear how the requirements as currently drafted would apply to schemes structured in a different way.

Impact on DB consolidation

An alternative approach to setting up a sectionalised scheme, which is particularly relevant to DB consolidation, could include sections being independently governed by separate section trustees – with section trustees being responsible for all decisions regarding investment and funding for only their particular section – rather than these activities being carried out by governance committees or the responsibility of a central scheme trustee.

Under such a model, the central scheme trustee could be a "bare trustee" that has legal ownership of assets but invests only on the instruction of the relevant section trustees. The scheme trustee would have no decision-making powers regarding funding or investment for any sections, and likely would not have information on section-level liabilities or employer covenant as these matters would not be part of the scheme trustee's role. In particular, there would likely be no "usual way" in which a scheme trustee of this nature would obtain data or share reports relevant to funding and investment strategy with the section trustees.

We believe the ability to have "section-driven governance" of this nature is important for the success of DB consolidation, including for vehicles which currently use such a model and new vehicles which could be developed along similar lines.

For many DB schemes and their employers, the ability to have section-driven governance – including being able to appoint an existing scheme's trustees as section trustees when moving into a consolidation vehicle – is critical in the decision whether or not to consolidate. It is also an important feature to allow for diversity of trusteeship and diversity in approaches to risk management across a consolidation vehicle.

It is not clear to us how the regulations and guidance as currently drafted would apply to such an arrangement, assuming that the overall scheme had more than £1 billion of assets and a number of sections with small levels of assets significantly below the £1 billion threshold (e.g. a section with £50 million of assets). In particular:

- A central bare scheme trustee might be legal owner for more than £1 billion of assets, however if they do not have decision-making powers over investment or funding strategy – or over the processes used to make those decisions – then in our view there is limited value in that scheme trustee being subject to the requirements, and it is uncertain how the requirements could be interpreted.

- In our view, it would be inappropriate for a group of section trustees responsible for say a £50 million section to be subject to the requirements. The costs of compliance are unlikely to be proportionate in the way they might be for a larger scheme with more than £1 billion of assets.

This lack of clarity could be a barrier to DB consolidation. If a £50 million scheme was considering joining a consolidation vehicle, they might be discouraged from doing so if they (rightly or wrongly) perceived a risk that by consolidating they would become subject to additional compliance requirements designed for much larger schemes with a much larger budget for spending on governance activities.

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The result of such a barrier would be to hinder the Government's aim to encourage DB consolidation, and for fewer small and medium-sized pension schemes – and their members, trustees and employers – to benefit from the cost reduction and governance improvement advantages which consolidation can offer.

Avoiding unintended consequences

We welcome that in some areas the Government has sought to avoid disproportionate costs for schemes in drafting the new regulations. However it appears to us that these measures focus on trustees only being required to take proportionate steps in relation to potential gaps in data availability, and carrying out analysis such as scenario analysis and calculation of metrics as far as trustees are able, rather than any wider proportionality considerations around – for example – how the requirements might apply to sectionalised schemes.

We believe it should be possible to update the regulations and guidance to:

- recognise that sectionalised schemes might be structured in different ways
- make clear that within sectionalised schemes, the requirements only apply to trustee boards that have decision-making powers in relation to the funding and investment of pension scheme assets in excess of the £1 billion threshold.

This would achieve the intended aims of the regulations, and those trustee bodies with responsibility for large pools of assets – who are more likely to be in a position where their stewardship approach might influence firms towards business practices that give due consideration to climate risk – would be subject to the requirements.

At the same time, it would enable trustees who are responsible for smaller levels of assets to consider consolidation and the benefits it can offer, without a perceived risk of becoming subject to disproportionate requirements in relation to the assets and liabilities they are responsible for.

Summary

We believe that the regulations and guidance as currently drafted could have a negative impact on the Government's desire to encourage DB pension scheme consolidation. However, it should be possible to update the regulations and guidance to avoid unintended consequences, while allowing the Government to implement the climate risk requirements as intended.

We acknowledge that there would be some detail to be worked through in terms of how precisely the regulations and guidance should be updated. We would be pleased to engage with the Department for Work and Pensions on this if that would be helpful.

Please let me know if you would like to discuss any of the points in our response.

Yours faithfully

Mark McClintock

Mark McClintock
Deloitte Pensions Services Limited