TAKING ACTION ON CLIMATE RISK: CONSULTATION ON REGULATIONS

10th March 2021

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10 March 2021

Dear Emma, Tom and David

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

Redington Ltd is delighted to respond to the above consultation. We are broadly supportive of the proposals set out and welcome the increased focus on climate risk for pension schemes. We agree that better disclosure should lead to better decision-making and better outcomes for pension scheme members.

We welcome the amendments to the proposals following the August 2020 consultation, around scope and timing for implementation. There are areas where we think further clarification would be useful, especially on the subject of metrics and targets. We believe that the focus should be on ensuring that any metrics and targets that trustees set drive decision-making. There is otherwise a risk that the metrics are not useful and become a mere box-ticking exercise.

Redington is an independent consultancy based in London. We advise a range of long-term investors, including DB, DC, private wealth and insurance clients. Our mission is to help make 100 million people financially secure.

Yours sincerely,

Carolyn Schuster-Woldan & Edwin Whitehead

Question 1

Scope and Timing

a) **Do you have comments on the proposals to change the "reference date" used for the purposes of determining whether a scheme is in scope, or the arrangements made for schemes which obtain their audited accounts later than 1 October 2021, or 1 October 2022?**
b) **Do you have comments on the draft regulations on scope and timing?**

We welcome the amendments that have taken place in this section since the August consultation.

Focusing first on the scope, we support the decision to explicitly carve out bulk annuity contracts from the asset threshold test. Given the illiquid nature of these assets, we do not think aligning with the recommendations of the TCFD is a decision-useful process for trustees to undertake.

In terms of the refinements that have been made to the timing of the implementation roll-out, we see these changes as positive. The move to allow a full 7-months from the scheme year end date to produce a report should ensure standards are maintained as opposed to the previous one size fits all ultimate-deadline of December 31st. We also welcome the transition to a March 1st reference date.

One area where we feel further clarity could be provided is on what the 1st October implementation date means in practice.

We appreciate the increased urgency in reviewing the position for smaller schemes which has now been brought in to the second half of 2023.

Finally, we are comfortable that the draft regulations are for the most part clear and accurately reflect the policy intent stated in the chapter.

Question 2

Trustee knowledge and understanding
a). Do you have any comments on the draft regulations on trustee knowledge and understanding?

b). Do you have any comments on the draft guidance?

We are comfortable that the draft regulations in this area make clear the requirement for trustees to ensure that they hold an appropriate understanding of the assessment, identification and management of risks and opportunities related to climate change. By not being too prescriptive, the regulations should engender careful consideration by trustees of this area rather than becoming a box ticking exercise.

An area that we thought could be given a larger weighting in the non-statutory guidance is that of promoting industry collaboration as best practice. We are currently part of a cross-industry collaborative group of 17 UK investment consulting firms on the Investment Consultants Sustainability Working Group (ICSWG). This was formed in 2020 as a response to the PCRIG consultation. In January 2021, a guide to help trustees assess the climate competence of their investment advisors was launched. Our experience in this group has reaffirmed our belief that the regulator should, where possible, endorse a collective responsibility for continuous improvement by the industry.

Examples of innovative approaches to embedding the recommendations of the TCFD should be promoted by the Pensions Regulator. Providing resources and support to trustees should be a key focus in the initial years of the implementation.

We consider that the draft guidance reflects the policy intent stated in the chapter. This will, however, need to be a living document that evolves with best practice.

Question 3

Governance
a). Do you have any comments on the draft regulations on governance?

b). Do you have any comments on the draft statutory guidance?

We are in broad agreement with the draft regulations on governance and note that this is largely unchanged from the August consultation. We welcome the clarification on "persons managing the scheme" and are acutely aware that the day-to-day responsibilities of managing a pension scheme can sometimes fall on external advisors (including investment consultants). As previously noted, we think that the ICSWG climate competency framework is a useful tool for trustees to use when assessing their investment advisor.

We agree that the statutory guidance reflects the policy intent stated in the chapter.

Question 4

Strategy
a). Do you have any comments on the draft regulations on strategy?

b). Do you have any comments on the draft statutory guidance?

We are in agreement with the provisions on strategy that have been provided in the both the drafted regulations and statutory guidance.

Question 5

Scenario Analysis
a). Do you have any comments on the provisions on scenario analysis in the draft regulations?

b) Do you have any comments on the proposal that relevant contracts of insurance are within scope for scenario analysis?

c) Do you have any comments on the draft statutory guidance on scenario analysis?

The proposal to ease the requirement of conducting scenario analysis to a triennial basis as opposed to the original annual proposal is welcomed. As discussed in our original response, the requirement to conduct annual scenario analyses would likely prove onerous for trustees. It is also useful that DB schemes should be able to align this with their triennial valuation process. This will help them to identify and document how climate-related considerations are factored into the assessment of the sponsor covenant and the actuary's assessment of the scheme's liabilities.

The value of annual scenario analysis is also somewhat dubious, especially during years where a scheme's strategy remains largely static. We think that scenario analyses should, however, be conducted when undertaking an investment strategy review.

We note that to meet the "as far as they are able" clause trustees will be required to understand the shortcomings of any proposed scenario analysis so that they can justify the tests that they have opted to conduct. Trustees will be reliant on their advisors to determine the appropriate level at which this analysis is also undertaken.

We would also welcome additional guidance on what constitutes a "light touch review in the intervening years" between the triennial requirements.

Question 6

Risk Management
a). Do you have any comments on the draft regulations on risk management?

b). Do you have any comments on the draft statutory guidance?

While we note that no additional changes have been made to the original policy proposals on risk management, we would like to reiterate the importance of a scheme taking an integrated holistic view of all the risks they face (including climate change).

We are comfortable with the draft statutory guidance in their current form.

Question 7

Metrics
a). Do you have any comments on the draft regulations on metrics?

b). Do you have any comments on the draft statutory guidance?

We welcome the additional clarity provided in the statutory guidance towards the metrics that trustees should be adopting to monitor their climate-related financial risk. We are in agreement that an absolute emissions metric should be mandated given its intuitive nature and applicability across asset classes. However, we question the recommendation of Carbon Footprint over Weighted Average Carbon Intensity ("WACI") as the default intensity-based metric.

We believe that many of the critiques of WACI are also relevant for Carbon Footprint. Namely, that WACI only covers listed equities and corporate bonds. Given the equity ownership approach used to deduce Carbon Footprint, we believe that this metric is most robust when used to measure listed equities and has a lower asset coverage than WACI. We also note the Carbon Footprint requirement of having access to underlying issuer market data as a limitation that does not apply to WACI.

Each metric has its strengths and its limitations. We think there is merit in the guidance recognising that different emissions metrics can be used for different reasons within a scheme's climate risk monitoring and management processes (e.g. WACI is a measure of an investor's exposure to carbon emissions, whereas carbon footprint measures the portfolio's carbon efficiency per investment value). We think additional clarity on the reason for recommending carbon footprint as a primary intensity metric for trustees to measure would be welcome.

The focus on scope 3 emissions is appreciated but we think more clarity could be further provided. Namely, what is the protocol for reporting scope 3 emissions when coverage is not available. If this is simply recorded as a zero, this could incentivise companies to simply not attempt to increase the scope of their reporting coverage. This should be addressed within the statutory guidance – one solution could be to attribute a firm with the average scope 3 emissions for their sector if they have not reported their own.

The extension of the "as far as they are able" provision to both the calculation and use of metrics is pragmatic. This concept recognises the data gaps that trustees are not able to obtain for the purposes of carrying out scenario analysis or calculating metrics. Trustees should not be expected to spend disproportionate amounts of time or money attempting to fill data gaps if it's unlikely data can be obtained. Trustees should also explain in their TCFD report where this clause was exercised, set out what data is missing and the impact this has in terms of the scope of analysis.

As advocated in our original response, we welcome the decision to transition to an annual rather than quarterly requirement for the monitoring of metrics. Our initial hesitation towards the mandating of quarterly monitoring was that this would lead to short-termism and unintended consequences, and not be helpful for taking long-term decisions.

Question 8

Targets
a). Do you have any comments on the draft regulations on targets?

b). Do you have any comments on the draft statutory guidance?

We support the amendment to the original proposal to provide quarterly performance monitoring against a set target. The transition to having an annual requirement should minimise the risk of taking too short-term a view e.g. divesting rather than engaging from carbon-intensive investments.

We also agree that any targets should be reviewed on an annual basis by the trustees. However, we caution the possible unintended consequences around changing targets too frequently.

Question 9

Disclosure
a). Do you have any comments on the draft regulations on disclosure?

b). Do you have any comments on the draft statutory guidance?

We are comfortable that the draft statutory guidance reflects the policy intent in this chapter. Overall, we have no concerns.

Question 10: Penalties
a). Do you have any comments on the draft regulations on penalties?

No comment.

Question 11: Impacts
In relation to the policy changes we have made, do you have any comments on the regulatory burdens to business and benefits, and wider non-monetised impacts which are estimated and discussed in the draft impact assessment?

We agree with the wider non-monetised impacts laid out in the impact assessment as we are fully supportive of the policy objectives and intended effects of the regulations.

While the costs presented in the impact assessment are somewhat more accurate than the costs estimated in August, we think the overall cost of pension schemes establishing governance processes and reporting in line with the TCFD is still materially underestimated. We broadly agree with the relative cost split for familiarisation, scenario analysis, metrics & targets and producing the report, although we note that these costs will vary significantly based on asset size, provider selection and the extent of in-house resource vs consultant resource used. However, we do not think that the impact assessment accurately reflects the costs schemes will face in the first year of compliance. We do not agree with the impact assessment's assumption that schemes already have all the governance, strategy and risk management processes in place. While fiduciary duty requirements mean schemes are taking into account climate change as a material risk, the processes required as per the regulations are more specific and a majority of schemes in scope will need to revise current processes and likely establish new processes to meet these requirements. As such, the governance and process-related set up costs are likely to be material and the impact assessment does not currently account for these at all.

As per our previous response, we recommend that a survey of industry participants is completed after the first year of regulatory compliance, asking what the actual costs have been in terms of additional trustee, consulting and asset manager time.

Question 12: Any other comments
Do you have any other comments you would like to raise?

One additional consideration that we wanted to raise was around the difficulty in using Enterprise Value Including Cash ("EVIC") to attribute emissions. Using this metric means holders of debt have the same emissions as equity holders, however they are not exposed to the same degree of climate-related risk (price risk vs. default risk). We understand this is in line with some industry standards, however we would like to flag as a potential issue as it makes investing in the debt of higher carbon sectors relatively less desirable. Pension schemes are increasingly becoming lenders of capital rather than owners of businesses. It could be monitored whether emissions are key drivers of decisions rather than a holistic measure of risk (similar to how engagement vs. divestment should be monitored). This may drive unintended consequences e.g., over pricing of debt in low carbon sectors, and punitive costs of capital in sectors that need to finance their carbon transition plans, thus making the transition less likely. These consequences are hypothetical at this stage, but realistic hence our view it should be monitored.