Taking action on climate risk

Aon is pleased to submit its response to the DWP's consultation on the *Occupational Pension Schemes (Climate Change Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021.*

Aon is a leading global professional services firm providing a broad range of risk, retirement and health solutions, with more than 50,000 colleagues in 120 countries. We work with the trustees and sponsors of around 1,000 UK pension schemes. Globally, we work with more than 2,300 clients with assets totalling $3.8 trillion.

Executive Summary

Aon supports the principles set out in the response to the August consultation and welcome the majority of the updates that addressed the comments we highlighted in our previous submission. The response provides clarity particular around the scope and timing of the proposals. With that said, some nuances around strategy and metrics could be further addressed or clarified, which we have included in our response.

We look forward to the outcome of this consultation and to further engage with DWP, TPR and other stakeholders on these critically important issues.

Prepared for: The DWP
Prepared by: Aon
Date: 10 March 2021

Consultation Questions

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?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) We welcome and support the change of reference date, which means more schemes know earlier on whether and when they are within the scope of the new requirements. We also support the change to the TCFD reporting deadline as well as the provision to carve out bulk and individual annuity contracts from the asset threshold criterion, both of which we raised in our response to the preceding consultation.

b) We do not have any comments on the draft regulations.

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b) Do you have any comments on the draft guidance?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) We support the policy proposals on trustee knowledge and understanding. In our experience, most trustees recognise that climate change can have a financially material and detrimental impact to their schemes but may be less clear on (1) what they need to do to manage the risks and opportunities associated with climate change and (2) what is required of them by law and regulation.

b) We do not have any comments on the draft guidance.

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?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) We support the policy proposals on governance.

b) We do not have any comments on the draft statutory guidance.

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?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) We do not have any comments on the draft regulations.

b) We agree with the thrust of the draft statutory guidance on *Strategy*. However, we would welcome additional guidance on whether trustees can exclude assets from consideration, at least initially, on the grounds of materiality as determined by size of investment.

In our experience, schemes with assets in excess of £5bn – and indeed those with assets in excess of £1bn – tend to have portfolios that are highly diversified by asset class, sector and region, which can make a full climate risk and opportunities assessment on all assets impossible to do before the 1 October 2021 deadline or prohibitively expensive. While we agree that trustees should not start from the assumption that climate change is irrelevant for some assets or sectors, we would welcome clarity – potentially through non-statutory guidance – with respect to how trustees should think about materiality/proportionality at scheme level. For example, if a scheme holds 0.1% of its assets in an asset class that is exposed to climate risk, can a trustee board choose to exclude that asset class from consideration because it makes up a small part of the scheme's overall investments?

With respect to covenant, the back-stop for all risks in a DB scheme is the covenant of the sponsoring employer and the impact of climate risk on an employer should be assessed as part of the covenant analysis. This is consistent with TPR's focus is on Integrated Risk Management, whereby Investment and Funding strategy are informed by the financial strength and risk absorbing capacity of the underlying employer. The impact of climate risk on employers will vary widely depending on the sector and specific circumstance of the employer and, therefore, a proportionate approach is required. Even without regulations/legislation on climate risk, trustees and covenant advisors are already starting to factor in climate risks on the sustainability of the employer's business and therefore its ability to support the financial obligation and risk in a DB scheme.

We expect that trustees (and companies) will have a major concern about disclosing sensitive non-public information which they are party to as part of employer covenant or wider discussions regarding climate change risks relevant to that scheme. For this reason, we think it would be worthwhile having a carve-out for censoring non-public information when reporting back the climate change risks and opportunities identified for that scheme.

For DC schemes, while the focus on popular defaults should ensure a proportionate approach we note that many master trusts will have multiple defaults in place, including those created as 'deemed' defaults for fund mapping purposes. The requirement to report on all such defaults would create additional reporting / costs and may be disproportionate to the assets / number of members invested.

Additionally, for DC schemes, we believe it is important to reflect the member experience rather than just considering the default strategy as a whole. Specifically, the impact of climate risk / opportunities assessment will be different for members at different points in their savings journey, for example, a saver just starting their career compared with a member at the point of retirement.

Being able to present the analysis / metrics for a sample of different members would provide more meaningful and useful analysis, in our view.

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 all assets of the scheme, including relevant contracts of insurance, are within scope for scenario analysis?

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

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) We welcome the provisions and guidance on scenario analysis and we broadly welcome the recommendations. There is currently no discussion around what the baseline scenario should be, which in our view is needed to assess the relative impact of different scenarios. We would recommend having a scenario based on market consensus and narrative that aligns with this consensus.
We would welcome guidance on stress test scenarios and the degree of shock that should be modelled. We have noted that some climate change scenarios on the market are likely to be severely underestimating the impact of the physical and transition risks and are therefore likely to give a misleading impression of the risks around climate change.

We disagree that a <+1.5C should not be considered now. The milestones set out for a transition to <+2C and <+1.5C are well defined and there is enough information to provide scenarios that are different. The difference between a <+1.5C and <+2C in end outcomes are meaningful and the additional +0.5C will impact biodiversity, society, economies and markets markedly.

With respect to covenant, it is important to avoid spurious accuracy in trying to quantify the difference between a 1, 2 or 3-degree changes in temperatures relative to pre-industrial levels. Most covenant analysis is driven by a mix of qualitative factors (range of employers' products/services, consumer trends, competition, substitutes, etc) and quantitative factors (e.g., forecast of an employer's free cash flow and the size of its financial obligations). TPR uses a 4-bucket scale to grade covenant strength which avoids spurious accuracy.

b) While assessing a broad range of asset classes should be the end goal, it should be noted that climate change disclosures and supporting ESG metrics are at an early stage, which means non-core assets (outside of equities and fixed income) are harder to model, such as private markets, and therefore more leeway in their modelling is needed until better information becomes available.

While modelling climate change scenarios for pension schemes and insurance companies has some overlap, the end outputs needed to stress test these organisations are likely to vary, to appropriately provide a sufficient stress test.

c) We welcome the guidance and look forward to its implementation.

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?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) We support the policy proposals on risk management.

b) We do not have any comments on the draft statutory guidance.

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?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) The alternative metrics proposed will likely lead to data quality being the main additional metric adopted, as it is comparatively low effort to collect and has the lowest reporting risks.

Paris Alignment metrics are in development but the majority available today are of relatively poor quality. It is likely these metrics will suffer from the same issues as early ESG data, where there are no recommended standards and guidance on underlying methodology. Taking a more holistic view of metrics should be preferred when considering Paris Alignment. We note, however, that the TCFD recently consulted on the development and use of climate-related metrics, with a focus on the implied temperature rise metric. This may lead to greater standardisation and usability, but at present our view is that data quality issues and lack of standardisation remain a major barrier to adoption of these forward-looking metrics. Carrying out climate change VaR exercises tend to be prohibitively expensive, except for the very largest companies and pension schemes.

b) We welcome the statutory guidance. However, with respect to the absolute emissions metric, parts 117 and 118 of the guidance state that trustees should use total GHG emissions as their absolute emissions metric but does not state that this should be a scheme's **share** of emissions (the intensity metric section does state that trustees should calculate intensity weighted by size of the investment). We assume that the intention is for absolute emissions to be reported based on a scheme's share so would welcome clarification on this point.

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?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

a) We support the policy proposals on targets. The draft regulation and statutory guidance provide a balanced way forward for measuring progress towards a net-zero emission economy.

b) We support the move from quarterly to annual reporting.

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?

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

In line with our comments on the preceding consultation, we support the proposed approach in this area and have no further comments.

Question 10 – Penalties

Do you have any comments on the draft regulations on penalties?

Please include in your answer any comments you have on whether you consider that they meet the policy intent stated in this chapter.

In line with our comments on the preceding consultation, we support the proposed approach in this area and have no further comments.

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 believe that the updated impact assessment more accurately reflects the costs that trustees will incur to meet on the new governance and reporting requirements. However, we believe that the central range is likely to be an underestimate; for many schemes, the cost will likely be towards the upper end of the range quoted in year 1.

Question 12 - Any other comments

Do you have any other comments you would like to raise?

We welcome the further clarification that has been provided on the definition of "as far as they are able" as set out in the guidance.

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