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10 March 2021

Dear Emma, Tom and David

Consultation response - taking action on climate risk: improving governance and reporting by occupational pension schemes

Thank you for inviting responses to your 27 January 2021 consultation on draft regulations and statutory guidance requiring pension schemes to have, and to report on, effective governance in relation to climate-related risks and opportunities (the "**Consultation**"). This letter sets out our response to the Consultation. We would be delighted to meet with you to discuss the proposals and the comments in this letter further if that would be helpful to the Department in ensuring the proposals achieve the policy objectives.

Travers Smith LLP is a firm of solicitors with one of the largest specialist pensions law departments in the City of London. We act for trustees and sponsors of a wide range of occupational pension schemes. Our clients include many trustees and providers of authorised master trusts and schemes with assets exceeding £5bn or £1bn who would become subject to the proposed new duties during the first and second phases of implementation (proposed for 2021-2023 in the Consultation).

The Consultation covers:

(a) the draft Occupational Person Schemes (Climate Change Governance and Reporting Regulations) 2021 which set out the principal substantive governance and reporting duties under the Department's policy (the "**Main Regulations**");

(b) the draft Occupational Pension Schemes (Climate Change Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021, which cover trustee knowledge and understanding, registrable information and amendments to disclosure regulations (the "**Miscellaneous Regulations**"); and

(c) draft statutory guidance supplementing the above.

We have not sought to answer all Consultation questions about these materials, and instead have aimed to address those aspects where we can provide insights from a commercial legal perspective. Having responded to the Department's earlier consultation on the policy proposals in this area, our response to this Consultation focuses on areas where we would suggest changes to the draft materials in order to give effect to the stated policy intention, avoid unintended or adverse consequences, or improve clarity. On that basis, many of our comments concern matters of technical legal drafting, and so for ease of use we have set them out in a table in the attached Appendix with reference to the draft provisions we are commenting on in each case.

We hope this response is useful to the Department. At a high level, whilst the structure of the regulations is clear (particularly in the schedule) we have identified some important points where further clarification would, in our view, assist in achieving the policy objectives. In particular we would encourage the Department to consider clarifying the timing requirements applicable to a number of the particular duties and activities under both the Main Regulations and the Miscellaneous Regulations. We would also encourage the Department to explore whether it can work with the industry to provide more comprehensive guidance to trustees around the new TKU duties. These points are discussed in further detail, with others, in the Appendix.

We would be very happy to discuss this response, or any other aspect of the proposals, further. Please contact our Pensions partners Andy Lewis (andrew.lewis@traverssmith.com) or Susie Daykin (susie.daykin@traverssmith.com) if this would be helpful.

Yours sincerely

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APPENDIX

Q	Subject	Draft provision	Travers Smith comment
1	Scope and timing	Regulation 2(11)(h)(ii), Main Regulations – definition of 'relevant assets' in an earmarked scheme	It seems possible that this definition could lead to a negative figure for relevant assets in some cases. We are not sure whether this causes an issue from a policy perspective.
		Regulation 2(11)(i)(i), Main Regulations– definition of relevant contract of insurance	We suggest deleting the words "in all circumstances", "fully" and "and which are, or will become, payable in accordance with the scheme rules". After these changes, the remaining language would describe payments by an insurance company to the trustees which meet the cost of specified benefits which are not money purchase benefits – and this is, in our view, sufficient to capture the nature of a buy-in or annuity contract. The additional wording referring to fully meeting benefits under scheme rules in all circumstances, could create uncertainty about whether or not to exclude the contract when calculating relevant assets if there is a mismatch, international or otherwise, between the benefits secured under the policy and the benefits payable under the scheme: see our comments on the assets in scope for scenario analysis for further detail on the reasons why these mismatches may arise. As currently drafted, it seems to us that this provision could therefore lead to uneven treatment between schemes under the Main Regulations, depending on the specific characteristics and circumstances of the scheme and its insurance contracts. We do not think that outcome would be consistent with the policy intention expressed in the Consultation in this area.
		Regulation 2(11)(j)(ii)(bb) – definition of scheme year	We think the reference to paragraph (aa) in this provision should be to paragraph (i), since paragraph (aa) does not refer to a year or period.
		Regulation 2(11)(k) and (l) – definitions of scheme year commencement date and scheme year end date	In our view the interpretation of these terms is clear from the ordinary and natural meaning of the words used, so these specific definitions could be removed if the Department wishes.

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2	Trustee knowledge and understanding	Regulation 2, Miscellaneous Regulations	The timing of these requirements is not entirely clear. The phrase "in the case of trustees to whom requirements under [Part 2 of the Main Regulations] apply…" could be interpreted to mean either (i) all trustees of trust schemes or (ii) those trustees who have become subject to the substantive governance duties because their scheme has hit a relevant trigger point in the phasing-in provisions of the Main Regulations. Based on the Consultation and the draft statutory guidance we believe (ii) may be the policy intention (and we would agree that is a reasonable approach). To achieve this within the Miscellaneous Regulations, an alternative formulation might be "in the case of trustees who must comply with the requirements of Part 1 of the Schedule to [the Main Regulations]…". This aligns more closely with the drafting of the timing and scope provisions in the Main Regulations.
		Statutory guidance Part 2 paras 28 – 34	A number of respondents to the policy consultation, including us, pointed to a need for upskilling in relation to climate risks and opportunities in order to help trustees carry out their new duties effectively. Whilst placing a legal TKU duty on trustees is a logical response, changing the law is only a partial solution. Understandably, the Miscellaneous Regulations can only define at a high level what trustees need to know. Against that backdrop, we believe that the current draft guidance (which we agree should be non-statutory in this area) does not offer a sufficiently practical steer to trustees on precisely what trustees need to know, and how to learn about it. In particular: • Paragraph 31 of the draft guidance only gives the briefest, non-exhaustive, list of relevant topics. • The intention of paragraph 32 seems to be to describe how trustees could strike an appropriate balance in their level of knowledge. However, the current drafting appears ambiguous. On the one hand it says trustees "need not" master technical detail. On the other, it sets an expectation that trustees should be able to interpret the results of "any analysis" and be able to challenge assumptions, external advice and information. We think this will leave some readers uncertain as to exactly where the right line for compliance with the TKU duty lies. As a minimum we would suggest amending paragraph 31 to add references to possible relevant sources of information, including consulting professional advisers, and amending paragraph 32 to state that the duty "<u>does not</u>" require mastery of technical detail. However, we believe further action would be needed in order to address the practical challenges more comprehensively. We agree with Hymans Robertson's suggestion, quoted in the Consultation, that TPR's Trustee Toolkit should be extended to include a module covering this area of TKU. In our view, there is a wealth of existing 'raw material' and recommended reading, including the sources quoted in PCRIG's non-statutory guidance. This could form a basis for TKU, but it needs to be adapted and further organised and clarified for its audience. We would encourage the Department to carry out further work with PCRIG, and/or bodies representing the industry or professional advisory communities (since professional advisers are

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			likely to play a key role in delivering TKU training in many cases), to build a more comprehensive best practice syllabus that trustees could follow. This could be adopted within future editions of the statutory guidance.
3	Governance	Schedule Para 2(a) and (b), Main Regulations and statutory guidance Part 3, paras 11-12 – oversight of persons who advise or assist with respect to governance activities	We note that paragraph 2(a) requires oversight of all persons undertaking governance activities in relation to the scheme, with, in contrast to paragraph 2(b), no limitation by reference to climate risks or opportunities which are relevant to the governance activities that person is carrying out. The phrase "persons who undertake governance activities" is not specifically defined within the Main Regulations, and could be open to a wide interpretation. For example, the current provision could arguably bring scheme minute-takers into scope of this paragraph, requiring climate-related oversight of them - even though identifying, assessing and managing climate risk and opportunities would not be relevant to their role. Based on paragraphs 11 and 12 of the statutory guidance, we do not think this is the policy intention. Rather we think the intention is for "persons undertaking governance activities" to mean the class of people who make substantive governance, strategy or risk decisions in relation to the scheme. To achieve this, we suggest the Department considers (i) introducing a "climate relevance" qualifier to paragraph 2(a) that is similar to that already included paragraph 2(b), and/or (ii) expanding paragraphs 11 and 12 of the draft statutory guidance to include more detail on the intended meaning of persons "undertaking governance activities". In paragraph 2(b) of the Main Regulations the phrase "advises or assists" is similarly widely drawn. On its face the phrase seems to capture a range of people involved in any advice or assistance with scheme governance where there is a climate dimension in their work, irrespective of the nature or level of their involvement. For example, is it the policy intention that a digital board packs provider appointed by trustees to provide a platform for managing meeting papers and recording decisions online (which could be said to be assisting the trustees with scheme governance and which may include climate-related matters) should be in scope for climate-related oversight by the trustees? Similarly, what about a communications consultant appointed to carry out a one-off review and refresh of the scheme's member-nominated trustee arrangements and communications which includes a description of the scheme's governance structures and approach to climate and other risks? Depending on the detailed policy intention, we suggest the Department considers either or both of (i) a further clarification in the drafting of these provisions or (ii) expanding the statutory guidance with further examples of providers that are considered to be in scope, and those that are not. Rather than seeking to create an exhaustive list of every conceivable form of "advice or assistance" on governance where climate is relevant, the Department could consider introducing a concept of relevance or proportionality around these requirements within the statutory guidance – for example oversight should only be required if the provider is giving material or ongoing advice or assistance in relation to substantive governance, strategy or risk decisions.

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4	Strategy	Schedule Paras 3 and 5, Main Regulations – carrying out strategy duties on an ongoing basis	We believe the phrase "on an ongoing basis" within these paragraphs creates legal uncertainty. Would a court interpret this as meaning 'regularly' (and if so, how regularly), 'continually' (which could be disproportionate for some schemes), 'indefinitely', or as some other term? We suggest the Department considers deleting the phrase "on an ongoing basis" from the regulations. The concept could instead be addressed either (i) without express language in the regulations, and explaining the policy intent within the statutory guidance alone (see Part 2 paragraph 12 of the current draft statutory guidance) or (ii) by aligning the timing language of the strategy duties more closely to the 'establish and maintain processes' concept that is used in the other 'ongoing' governance duties, e.g. paragraphs 1 and 11 of Part 1 of the Schedule.
5	Scenario Analysis	Scheme assets in scope	The consultation document asks whether buy-in and individual annuities should be excluded from the scope of the scenario analysis obligation. Our strong view is that they should be excluded (and such policies should be excluded from the scenario analysis for both partially and fully bought-in schemes). These contracts are, to all extents and purposes, irrevocable investments held by the scheme, in relation to which the Trustee can no longer make any further active investment decisions as a result of any analysis carried out. Further, we do not think there is any meaningful information that the Trustee can obtain from including such investments in the analysis. The policy is, in effect, an asset that matches certain liabilities of the scheme. The insurer will be holding assets to meet the insurer's liabilities (and on a collective basis), to which strict capital requirements apply. It will of course be important that insurers are, themselves, carrying out scenario analysis in relation to their total assets and liabilities, and that is where we think the focus of any TCFD governance and disclosure obligations should lie, rather than at the Trustee level. Indeed, from the scheme perspective, we think there is little, if any, meaningful insight that trustees will gain from the inclusion of such assets within the trustee's analysis and it is unclear what, if any, impacts could be assumed in any scenario chosen. The capital regime underpinning these policies, requiring insurers to continually hold appropriate levels of assets, failure to do so leading to PRA intervention and possibly transfer of business to another insurer, is likely to mean that trustees would find it hard to conclude that any scenario would have any impact on the value of the policy or the liabilities secured by it. Even worse, because of this, an unintended consequence of including such policies within the analysis, for schemes that hold a mixture of policies and other assets (i.e. a partially bought-in scheme), could mean that the overall scenario analysis, in relation to the other assets/liabilities held by the scheme and in relation to which trustees can make decisions, could be unduly distorted. Similar considerations, it seems to us, would also apply to the question of which assets should be in scope for the metrics and targets duties in paragraphs 14 – 16 of Part 1 of the Schedule to the Main Regulations. If insurance policies are to be effectively excluded, the definition of "relevant contract of insurance" will need amendment. The current definition only includes a policy which provides for payment which "in all circumstances" will "fully meet the cost of specified benefits….which are, or will become, payable in accordance with the scheme rules". The structure of most

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			policies is that trustees purchase a policy which cover certain liabilities, based on a "provisional" set of benefits that will be specified and priced by the insurer at the inception of the contract. At this point, there may be known inconsistencies between the provisional benefits insured and the actual benefits payable under the scheme rules. Before moving to buy-out, the trustees will then carry out further data and benefit adjustments to those initial benefits (for example, to adjust for GMP equalisation obligations or data corrections), to ensure that at the point of buy-out, there is alignment between the benefits secured and the benefits the Trustees believe are payable under the scheme rules. For schemes intending to move to buy-out in short order, this process will happen soon after contract inception. For schemes holding policies as long-term buy-ins, then this process may not happen at all; indeed there may be known circumstances where the policy will not "in all circumstances" cover the benefits payable under the scheme (normally because it would be inefficient to insure such a benefit and/or the circumstances make it unlikely the benefit would be payable, and with trustees taking the view that these are circumstances in which (if they occurred), the scheme or employer would need to provide for the payment of those benefits. Even for schemes intending to move to buyout, and even after any "data cleanse" process, trustees very rarely have absolute certainty that the benefits secured will absolutely match the benefits payable under the scheme in all circumstances, noting that there may be unknown or even known unknowns in relation to data or benefits on which trustees have had to take a view when specifying the benefits to insure. All of the above mean that we think a modification of the definition is needed if insurance policies are to be excluded. Potentially these concerns could be addressed by removal of the words indicated in our response to Question 1 above, and changing "assets" to "relevant assets" in paragraphs 7(a), 9(a), 14 (including 14(a)), 15(b) and 16(b). Finally, we have considered if there should be a separate statutory obligation for trustees to consider climate-related risks in relation to the insurer as a counterparty before selection. We do not think this should be mandated as a prescribed statutory requirement (or indeed, how this could be done without overstepping the trustees' other fiduciary duties or obligations in relation to securing benefits with policies of insurance). We think trustees may well start considering this as part of their overall assessment of the financial strength of the insurer, but that specific statutory prescription would be unhelpful.
		Part 2 para 17, statutory guidance – level of scenario analysis	This paragraph explains the level at which the strategy activities including scenario analysis should be carried out. For DB schemes with more than one "section" the guidance suggests this should be at the level of each section, noting that sections with similar characteristics can be grouped together. The term "section" is not defined.

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			In the DB context, it is sometimes the case that schemes will be formally segregated into legally separate "sections", where assets and liabilities are ringfenced from other sections (and with the sections quite often supported by different covenants). These segregated sections are effectively treated as separate schemes under some key areas of legislation including scheme funding, employer debt and the PPF regime. For segregated "sections", we think the guidance is appropriate. However, it is much more commonplace in practice for the term "section" to be used to simply denote the different benefit structures that might be provided under a scheme to different groups or categories of member (i.e. those joining before or after a certain date, or working for different parts of a business or group). From an investment and funding perspective, these types of informal benefit sections will not be legally segregated; indeed, trustees are unlikely to be able to identify any specific assets that relate to one section rather than another, with the liabilities and assets of the scheme being considered together for investment and funding purposes. It would be helpful therefore if the statutory guidance could also expressly confirm that "sections" for which assets and liabilities are not formally segregated can also be grouped.
		Schedule Para 7(a), Main Regulations – description of transition risks due to steps taken by governments	We recognise that the primary legislation refers to "steps taken because of climate change" (section 41A(2)(a), to be inserted into the Pensions Act 1995). However, this provision is not exhaustive and we do not think the phrase "any steps which might be taken (by governments or otherwise) because of the increase in temperature" within Paragraph 7(a) of the Schedule to the Main Regulations properly captures the sort of transition risks trustees are expected to consider as a result of the potential actions of governments etc in the chosen scenario. The relevant impact on assets and liabilities should not just be those actions that are taken "because of" the chosen increase in temperature, but (and more relevantly), also actions that are taken by governments "with a view to achieving that global average increase in temperature".
		Schedule Para 8, Main Regulations – timing of scenario analysis	We would suggest that greater clarity is provided within the Main Regulations around the timing requirements for carrying out a scenario analysis. Scenario analysis is a process which is likely to take a number of weeks or months to complete. So, what does the reference to "undertaken" within paragraph 8 mean, in the context of paragraph 6? Does it mean when the trustee has completed its consideration of the matters set out in paragraph 6? It would be useful to clarify this. We wonder if there may be better approaches to prescribing the timing requirements, as set out below. • The obligation as drafted is to "undertake" the analysis "in" the first scheme year to which the regulations apply. For the largest schemes caught by Main Regulation 2(1), the regulations will apply from 31 October 2021. If the scheme year ends on 31 December, then we think this means the scheme must carry out its first scenario analysis by 31 December 2021, in order to have "undertaken" the analysis "in" that scheme year. This is a very short period. We suggest that a better timing requirement would be that trustees are required to complete the analysis within a certain period after the end of the scheme year in which the requirements first apply.

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			• The output of the analysis is what the Trustee will publish in its annual TCFD report. Taking the above comments into account, we think it would make sense for the timing requirement for completing the scenario analysis to be aligned to the date by which that report must be published (i.e. no later than 7 months of the end of the first scheme year in which the requirements apply or the date by which the TCFD report is published if earlier). • The ongoing requirement to undertake out an analysis "every three years thereafter" is even less clear, if the first analysis is one which must be carried out "in" a scheme year, rather than "by" a certain date. What does "three years thereafter" mean in that context? Does it mean "in" the scheme year that is no later than the third scheme year after the year "in which" the previous analysis was undertaken? Or does it mean that the next analysis must be "completed" by no later than the third anniversary of the date on which the previous analysis was completed? • We think it would be much clearer if the relevant timing requirements was drafted by reference to an obligations to "complete" the first scenario analysis "by" a particular date, with an obligation to complete each subsequent analysis no later than the third anniversary of the date of completion of the previous analysis (unless the trustee has determined that a new analysis is required sooner in accordance with para 9). • The regulations do not prescribe the date as at which the relevant inputs (assets/liabilities/covenant) need to be assessed for the purpose of any analysis. Recognising this is a process, and recognising there are different matters to be considered, we think it is better to avoid prescription as to any specific date that must be used to assess the assets/liabilities/covenant (recognising that different dates may need to be used for different aspects of the assessment and analysis). However, it may be helpful for the statutory guidance to set out any expectations about the analysis being based on recent information.
		Schedule Para 9, Main Regulations – considering whether to carry out further scenario analysis	Consequential amendments to para 9 would be needed if the timing requirements in paragraph 8 were amended in line with the above suggestions. We think the policy intention is that the scenario analysis that is completed within a certain period after a scheme year effectively "relates" to that scheme year. If this connection is explicitly provided for in the regulations, then paragraph 9 could be expressed to be "In <u>respect of any scheme year in relation to which the trustees are not required to carry out a scenario analysis"</u>
		Schedule Para 10, Main Regulations	This requires the trustees to do scenario analysis more frequently than is prescribed by paragraph 8 where they have determined that they should do so. But this does not seem to alter the fixed triennial schedule in paragraph 8 – so trustees could decide to do new scenario analysis when not required and then be required to do new scenario analysis again the next or following year, even if they don't think they need to. This may make it less likely that trustees decide to do new scenario analysis out of the usual triennial cycle. Again this could be fixed by amending paragraph 8 to make it clear that the obligation is to complete the next analysis no later than the third anniversary of the date on which the previous scenario analysis (whether carried out under paragraph 8 or paragraph 10) was completed.

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		Part 3 para 70, draft statutory guidance	This paragraph suggests that Trustees should choose scenarios that reflect "their reasoned assessment of plausible pathways" and "should not focus on scenarios that rely on progress or otherwise, that they consider unlikely to happen". First, we do not understand the reference to excluding scenarios that rely on progress. We think many of the assumptions in relation to the impact on assets in different scenarios are those that are driven by the progress that is required to achieve the scenario (such as investment in the development of new technologies); in fact it is precisely the reliance on technology that is likely to be a significant assumption in relation to the scenario that is being considered. However, in any event, we do not think this is helpful guidance in relation to the choice of scenarios. Trustees are not climate scientists and do not have, nor should they be expected to have, the expertise to assess what scenarios are plausible or not, or the extent to which different scenarios are/are not dependent on progress and to what extent. We also note that the plausibility of different scenarios is not affected by individual scheme circumstances. It is therefore unclear, and we suggest an inefficient use of scheme resource, to require each set of trustees to whom the requirements apply, to individually have an obligation to assess plausibility of scenarios as part of the new obligations. We note the guidance refers to external resources which identify different reference scenarios (in particular those identified by the Network for Greening the Financial System and Annex 2 to the Climate Financial Risk Forum Guide to Scenario Analysis). Instead of current paragraph 70, and taking account of the above comments, we think it would be much more helpful for the guidance to confirm that Trustees can choose any of the scenarios that are referenced in the identified external resources referenced in the guidance (and which DWP can therefore update from time to time). This can either be in place of paragraph 70, or the guidance could clearly state that any of the scenarios set out in these resources can be assumed by trustees to meet the requirements of that paragraph. This will remove what seems to be unnecessary additional decision making by Trustees over matters which are not within their reasonable expertise.
7	Metrics	Schedule Paras 15 and 16, Main Regulations	These provisions require trustees to obtain scope 1-3 emissions data and other metric-relevant data "on an annual basis and as far as they are able". Because there is a specific definition of the term "as far as they are able", the phrasing of these provisions could be interpreted as creating a legal duty to collect the data more frequently than annually, where it is proportionate and cost-effective to do so (i.e. annually and whenever else it's proportionate and cost effective). We do not think this reflects the policy intention – which we understand to be to set the legal requirement at a level that requires data collection annually but no more frequently than that. We suggest deleting the "and", which removes the ambiguity – so that the phrase reads "on an annual basis as far as they are able".
		Schedule Para 14(c), Main Regulations and	This paragraph allows trustees to select one additional climate change metric for calculation and reporting (which is neither an absolute emissions metric nor an emissions intensity metric). We understand from the Consultation response that the policy intention is to provide flexibility to trustees in the choice of this third metric. However, the exclusion of absolute

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		Part 3, paragraph 134, statutory guidance	emissions and emissions intensity metrics within paragraph 14(c), coupled with paragraph 134 of Part 3 of the draft statutory guidance, effectively mandates a set "menu" of three metrics. The use of the term "should" in this paragraph of the guidance means that trustees must comply with this menu or explain why not. In our view it would be helpful to allow greater flexibility here – for example, some schemes may want to report on more than one absolute emissions metric; or on other metrics not on the paragraph 134 menu that are more specific to their scheme's circumstances. We would suggest deleting the words "which does not meet the description in sub-paragraph (a) or (b)" from paragraph 14(c) in the Main Regulations, and amending paragraph 134 of the draft statutory guidance so that this states that trustees "may" (rather than "should") select one of the three cited metrics and can choose other metrics.
7/8	Metrics / Targets	Schedule Paras 15, 16 and 18	These provisions all use the phrase "on an annual basis". The legal meaning of this phrase is unclear. If trustees do what is required in January one year, is doing it in December the following year acceptable? Or does it need to be in the same month, or even on the same date, every year? Or is something in between those extremes acceptable? We think that more precision is needed here in order to give trustees certainty about what is required.
8	Targets	Schedule Paras 18(a) and 21(o), Main Regulations	Further to the above comment about timing generally, these provisions require trustees to (i) measure against the target(s) they've set and (ii) report the performance of the scheme against those target(s) in the trustees' TCFD disclosures. As currently drafted, we think there is a risk that trustees will breach these obligations in the first year in which they become required to comply with the Schedule. We understand that the Department accepted that the data required to perform metrics and, as a corollary, to measure progress against targets, was largely available on an annual basis via annual financial statements provided by investee companies. If this is the case, then our view is that the Main Regulations currently require the trustees to measure performance against a target without having the data with which to perform this measurement. The Main Regulations should therefore clarify that the obligations to (i) measure against the target(s) they've set and (ii) report the performance of the scheme against those target(s) in the trustees' TCFD disclosures will only come into force in the second year that the trustees become required to comply with the Schedule.
9	Disclosure	Regulation 3(3), Main Regulations – chair's signature	The provision allowing the Chair's manuscript signature to be omitted from the published report is helpful, but could be used to argue that the DC chair's governance statement publication requirement does require the manuscript signature to be published, since there is no corresponding provision in those regulations. Please could a corresponding amendment therefore be made to the DC chair's governance statement provisions (perhaps via the Miscellaneous Regulations)?
		Schedule Para 21(b), Main Regulations	As a matter of drafting for consistency with the underlying governance duty in paragraph 2(a) of the Schedule, we believe this should refer to describing the role of "any person who undertakes governance activities in relation to the scheme otherwise than as a trustee".