ClientEarth

March 2021

DWP Consultation

Taking action on climate risk: improving governance and reporting by occupational pension schemes: draft legislation and draft statutory guidance

ClientEarth Response

Top Lines

- We welcome the Government's draft regulations and draft statutory guidance (**Guidance**), and strongly support the policy intentions behind the legislation.
- Whilst we have some reservations about the discretion afforded to trustees in relation to certain requirements, we recognise that, for the time being, this approach may be necessary in order to support progress on climate change action.
- Trustees should be explicitly encouraged in the Guidance to approach the regulations in the spirit of contributing to best practice, and should not be exploiting the discretion provided.
- Where measures are subject to the threshold "as far as they are able", the Guidance must continue to give concrete examples to ensure that these provisions do not allow trustees to opt out when analysis is difficult. In relation to scenario analysis, the "as far as they are able" qualification should only apply to quantitative analysis.
- We emphasise the importance of reporting on Paris alignment / Implied Temperature Rise (**ITR**) (particularly, in relation to metrics and targets), as soon as developments make this possible, and suggest that systemic risks and stewardship should be integrated within the Guidance and form part of trustees risk management processes.

- The Government's TCFD Roadmap must be rolled out rapidly and ambitiously in order to support trustees properly to fulfil the requirements set out in the regulations.
- The trustee knowledge and understanding (**TKU**) requirements should be applicable to trustees of schemes with assets below £1 billion, and further guidance or clarification is required as to how TKU requirements should be implemented.

1 Background

1. ClientEarth is a non-profit environmental law organisation based in London, Brussels, Berlin, Warsaw, Madrid, New York, Luxembourg and Beijing. ClientEarth's climate finance initiative conducts research and advocacy in relation to the legal implications of climate change-related financial risks for a wide spectrum of market participants, including companies, investors, company directors, their professional advisers and regulators.
2. On 27 January 2021, the Department for Work and Pensions (**DWP**) published its response to its consultation of August 2020 (the **August Consultation**) in relation to its policy proposals for improving governance and reporting by occupational pension schemes on climate-related risks and opportunities. As part of this response, the DWP is also consulting on draft legislation and draft statutory guidance that would enact the Government's policy proposals. The draft legislation is contained within the draft Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (the **Governance and Reporting Regulations**) and the draft Occupational Pension Schemes (Climate Change Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021 (the **Miscellaneous Provisions Regulations**).
3. This is ClientEarth's response to the new consultation (the **January Consultation**), which sets out our Top Lines (above), followed by overarching comments, and responses to selected questions.
4. Please do not hesitate to contact Joanne Etherton (jetherton@clientearth.org) or Kyla Taylor (ktaylor@clientearth.org) for further information on anything contained in this response.

2 Overarching comments

1. We welcome the Government's response to the August Consultation and support the ambition and approach taken in the draft regulations and Guidance in the January Consultation. It recognises that climate change and the zero-carbon transition create enormous risks and opportunities for pension schemes and the entire economy, and sets a clear plan to begin to address these issues.

2.1 Trustees should be encouraged to take a bold approach to the regulations

2. The consultation walks a pragmatic line between ensuring trustees take a more robust approach to climate change-related risk, commensurate with the challenges and opportunities it presents, and providing flexibility to address certain barriers to trustees fulfilling requirements within the parameters of their scheme's specific circumstances.

3. We hope that this flexibility will help to drive innovation and progress furthering the Government's policy intentions without further delay. However, it also raises the risk of poor responses by some trustees.
4. To counteract this risk, it is critical that the Guidance continues to make clear that an ambitious approach should nevertheless be taken ahead of the 2023 review.

2.2 "As far as they are able"

5. Undertaking scenario analysis, obtaining, measuring and calculating metrics and measuring the performance of the scheme against targets must now be fulfilled by trustees "as far as they are able". "As far as they are able" is defined as trustees taking "all such steps as are reasonable and proportionate in the particular circumstances [taking into account costs and time]".[1]
6. While we have some reservations about the flexibility afforded by the "as far as they are able" threshold being exploited by those trustees who may not wish to carry out particular requirements, in general we believe that this formulation strikes a proportionate balance given the limitations in data availability (subject to our comment on 'scenario analysis' in section 3.4 below).
7. It is, however, important that the Guidance continues to give concrete examples to ensure that these provisions do not allow trustees to opt out when analysis is difficult. The Guidance should also be clear that the Government expects to see fewer gaps and uses of the "as far as they are able" wording as the availability of data improves. The DWP should confirm that the first review in 2023 will be used to ensure trustees are complying as fully as possible with the spirit of the measures

2.3 Paris-alignment / ITR and systemic risks

8. Financial institutions' (including pension schemes) investment decisions and level of engagement will play a significant role in determining whether the goals of the Paris Agreement are met.
9. We understand that the Government has decided not to consult on calculating ITR as a measure of understanding and reporting progress towards alignment with the goals of the Paris Agreement at this stage, due to the need for further work on key methodological judgements and data inputs.[2]
10. However, we would like to reiterate the importance of this reporting for pension schemes. This is both due to the significance of temperature rise to the financial wellbeing of pension scheme members (including the systemic risks it poses to the economy as a whole, as explained further below), and to the Government's commitment to achieving net zero.
11. As the ICGN has highlighted[3], the production of investment returns to meet liability obligations, within a prudent level of risk, is a core obligation of those who invest on behalf of others, and it follows that consideration of system-level climate change risk (**systemic risk**) is embedded in fiduciary duty. Mitigating any potential effects to investments from systemic risk should therefore be considered as

[1] Governance and Reporting Regulations, Schedule 1, Part 1, para. 19.
[2] January Consultation, Ch. 1, para. 34.
[3] IGCN, 'Guidance on Investor Fiduciary Duties' (2018), p12.

part of that duty. Indeed, there is evidence of actors across the pensions industry identifying and responding to systemic risk.[4]

12. Climate change is an example of a systemic, macroeconomic risk that cannot be managed through portfolio construction or asset allocation alone.[5] Because unmitigated climate change will result in losses throughout the economy, across asset classes and sectors, scheme members' interests will be best met (and therefore trustees' duties best discharged) through efforts to ensure that warming is kept to a minimum. It follows that it is in scheme members' best interests that investment strategies support a swift transition to a low carbon economy that will help limit catastrophic global warming.

13. In our view, effective risk management by trustees and other universal owners is demonstrated where stewardship has a clear role to play exerting pressure both on investee companies and on government and policy makers with the aim that losses associated with the worst excesses of catastrophic climate change do not materialise.

14. We would like to see greater clarity provided in the Guidance that trustees should be taking into account systemic risk and integrate it into their investment and governance decisions. A further explanation could, for example, be included in the section, "Risks and opportunities", which suggests how trustees may find it helpful to split their analysis of risks into physical, transition and litigation risks, as well as integrating system-level risks within the section "Risk Management" (detailed further below).

2.4 Joined-up Government and regulatory action across the financial system will be fundamental to success

15. The January Consultation makes clear that some of the obstacles encountered around issues such as data and methodology gaps may be overcome as the Government's mandatory TCFD roll-out across the economy progresses.[6] The Roadmap is still indicative only, however, and plans across many sectors of the economy are still lacking. Whilst we are not suggesting that any amendments are made to the draft regulations or Guidance on this point, we consider that it is vital that the Government's wider plans are outlined and implemented as soon as possible, with at least the level of ambition shown by the Department for Work and Pensions in the August and January Consultations. This is necessary to support trustees properly to fulfil their obligations under the proposed regulations and to remove some of the barriers to responding comprehensively to climate change risk identified in the January Consultation.

3 Responses to selected questions

3.1 Question 2: Trustee knowledge and understanding

[4] See for example, the Law Commission's comments on "systemic considerations" in 'Fiduciary Duties of Investment Intermediaries'; industry bodies and regulatory initiatives which make direct reference to the need for investors to consider systemic risks; and widespread evidence of pension schemes and other institutional investors (e.g. the Brunel Pension Partnership and USS) considering systemic risks and strategically mitigating them.
[5] See CISL, 'Unhedgeable risk: How climate change sentiment impacts investment' (2015), Mercer, 'Investing in a time of climate change' (2015), Mercer, 'Investing in a time of climate change: the sequel' (2019)
[6] January Consultation, Ch. 1, para. 18 onwards.

16. We fully support the DWP's inclusion of a requirement for trustee knowledge and understanding (**TKU**) in the Miscellaneous Provisions Regulations and consider it supports the stated policy intent.[7] Proper provision for TKU is critical given climate change is material to investment and funding decisions and is (and, indeed, has been since climate change emerged as an investment concern) therefore already relevant to trustees' fiduciary duties. We agree that Regulation is necessary, however, as a result of the reported lack of TKU in relation to these matters "*and the significance of the risks climate change poses to pension savings and the financial system more broadly*".[8]

17. We consider that the TKU requirements are a logical clarification of sections 247(4)(c) and 248(5)(c) of the Pensions Act 2004 which states that trustees "*must have the appropriate degree of knowledge and understanding of these matters to enable them to properly exercise their functions*.". They importantly span the risk management process from identification, assessment and management of both risks and opportunities presented by climate change, encouraging trustees to have a comprehensive understanding of how climate change is relevant to their scheme and how they can both manage risks and capitalise on opportunities.

18. However, the Government should consider making the following amendments:

19. The scope of regulation 2 of the Miscellaneous Provisions Regulations should be expanded so that it is also applicable to trustees of schemes with less than £1 billion in net assets. We suggested in our response to the August Consultation (alongside, we note, other responders) that adoption of the Government's proposals should, in their entirety, be extended to trustees of schemes which fall below the £1 billion threshold. We acknowledge the Government's reasons for not doing so at this stage,[9] but feel that TKU should be an exception. Requiring TKU for trustees of smaller schemes would help bridge the governance gap between small and large schemes and prepare for the application of climate change governance requirements to their schemes, reflecting the Government's response in the January Consultation.[10]

20. The Guidance should provide more detail on TKU or confirm that tPR will incorporate further guidance into its existing Codes and guidance.

21. Given the reported lack of TKU described in the responses to the August Consultation and acknowledging that this requirement is subject to penalties, we believe that trustees would benefit from additional guidance. Guidance will provide trustees with further confidence and support to keep up-to-date in a developing area and to ensure all those who fall within scope are acting on a level playing field.

22. Currently, the Guidance in relation to this requirement is non-statutory and there are no requirements to provide an explanation of trustees' TKU in their TCFD reports. If there are to be no reporting requirements under tPR's regime, the DWP should add a requirement for trustees to disclose TKU activities that they have put into place or undertaken.

23. If, on the other hand, tPR will update Code 07and Scope Guidance to incorporate these requirements, this should be made clear. Trustees should then explain, in the annual chair's

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[7] That trustees should be able to understand the output of the activities they should take to adequately incorporate climate change into their investment and governance processes, including the ability to identify, assess and manage risks and opportunities presented by climate change.
[8] January Consultation, Ch. 3, para. 21 to 24.
[9] As set out in Part 2, para. 37 to 41 of the January Consultation.
[10] January Consultation, Part 2, para. 42.

statement, how they meet the requirements for appropriate knowledge and understanding, and how the trustees' combined knowledge and understanding (and the advice available to them) enable them properly to exercise their trustee functions.[11]

24. In order to enforce these requirements fairly, it is important that guidance is fit for purpose.

25. The wording of part 2, paragraph 33 of the Guidance should be amended to replace "are encouraged to" with "must". Keeping TKU up to date will be a pre-cursor to many of the other steps that will need to be taken and requiring that it is kept up to date is consistent with the requirement to have TKU in the first place.[12]

3.2 Question 3: Governance

26. We are supportive of the draft regulations and the Guidance and consider that they meet the stated policy intent. We are also particularly supportive of the Government's intention that processes are put in place to ensure that risks are appropriately managed by others who manage the scheme on behalf of the trustees. In our experience, climate risks often fall through apparent gaps in governance, where trustees say they expect their advisers and service providers to be managing climate risks while those same advisers are waiting for a pro-active instruction from the trustees.

27. We agree that the key focus of the scope of these provisions, in addition to trustees, should be those who provide advice or assistance with respect to the scheme's governance activities (rather than, for example, the legal framework underpinning governance activities). As described in the January Consultation, this means that legal advisers and asset managers who solely manage assets (and do not advise on governance activities) would not be covered. Nonetheless, these advisers have a key role to play in ensuring that trustees are supported to make robust, confident, evidence-based decisions in relation to climate change risks and opportunities, and an equal level of scrutiny should be applied to these groups by their respective regulators.

3.3 Question 4: Strategy

28. We are supportive of the draft regulations and Guidance and consider that they meet the stated policy intent. We welcome explicit requirements that trustees identify, assess and disclose the climate change risks and opportunities relevant to their scheme over the short, medium and long term. We have seen many instances of schemes purporting to delegate the management of climate risks to investment managers. This is despite consideration and management of climate risk being required by trustees' existing legal duties, and despite the nature of those risks necessitating robust management at all levels of investment decision making.

29. It is essential that the draft regulations and the Guidance continue to make clear that it is trustees themselves who must identify and assess risks and opportunities, albeit taking appropriate professional advice.

3.4 Question 5: Scenario analysis

[11] tPR, Code 07, available at: https://www.thepensionsregulator.gov.uk/en/document-library/codes-of-practice/code-7-trustee-knowledge-and-understanding-(tku)#e5d1a9cca5c04692a22e89d07c292683
[12] See Part 2, para. 28 and 29 of the Guidance.

30. Scenario analysis is a critical tool through which trustees can gain insight into the impact of climate change on their fund's investment strategy. We therefore strongly support the Government's decision to make scenario analysis mandatory for trustees (albeit on an "as far as they are able" basis, on which we comment further).

31. We also agree that the frequency of scenario analysis proposed[13] represents an appropriate balance between the need to ensure trustees keep their analysis up to date in a rapidly evolving field, and acknowledging the length of time that the process might take to complete.

32. However, we believe that the Government's stated policy aim would be better met by amending paragraphs 6 and 10 of Part 1 of the Schedule to the Governance and Reporting Regulations to ensure that carrying out scenario analysis in itself should not be subject to an "as far as they are able" qualification. This is because, in our view, qualitative assessment should be possible for any and all trustees, even where significant gaps in data are present. We understand that the "as far as they are able" qualification will be necessary for some aspects of scenario analysis – for example in relation to qualitative aspects. However, that should not weaken the provision that trustees must carry out scenario analysis. Indeed, the guidance itself anticipates that the main limitation to carrying out scenario analysis will be a lack of data, though this is not reflected in the wording of the Regulations themselves.

33. We would therefore suggest that the "as far as they are able" qualification applies only to quantitative scenario analysis, as this would give adequate flexibility in dealing with practical barriers.

3.5 Question 6: Risk Management

34. Having in place adequate processes for identifying, assessing and managing climate-related risks is crucial to ensuring good outcomes for scheme members. We are supportive of the draft regulations and Guidance and consider that (subject to the following points on system-level risks and stewardship) they meet the stated policy intent.

35. In our view, the omission of system-level risks in this section is a significant one. Given that climate change is a risk that cannot be managed through portfolio construction or asset allocation alone,[14] this section should include a discussion of both the importance of stewardship to effective risk management and – for the same reason - the need for trustees to consider the scheme's own actions to mitigate the impact of catastrophic climate change.[15]

36. Possible approaches to identifying and assessing these risks should be included in or around part 3, paragraph 88 of the Guidance.

3.6 Question 7: Metrics

[13] To be undertaken in the first year trustees are subject to the requirements and every three years thereafter, with an annual review.
[14] See CISL, 'Unhedgeable risk: How climate change sentiment impacts investment' (2015), Mercer, 'Investing in a time of climate change' (2015), Mercer, 'Investing in a time of climate change: the sequel' (2019)
[15] In our view, this can be seen as effective risk management by trustees and other universal owners, on the basis that doing so will ensure that warming is kept to a minimum and thus protect against losses across asset classes and sectors.

37. We welcome the Government's draft regulations and Guidance and believe that the proposed measures are sufficiently flexible to allow for the development of metrics and progression towards standardisation.

38. We also welcome the inclusion of Scope 1, 2, and 3 emissions within these metrics. While there will be some challenges to avoid double-counting, it is essential that what can be a significant proportion of investee emissions are not excluded by limiting emissions to scopes 1 and 2. Such a narrow focus would skew trustees' understanding of the relative risks of their holdings. We would, however, urge the Government to make clear that its stance on Scope 1, 2 and 3 emissions takes precedence over the (footnoted) GHG Protocol Methodology which is less clear on this point.

39. It is, however, our view that the Government should go further, as soon as developments allow, in requiring that trustees disclose alignment with the Paris Agreement and/or ITR. This is particularly important given the relevance of net zero to schemes' risk management (given the impact of higher levels of warming on pension scheme finances, not to mention the wellbeing of beneficiaries and the world they live in; see further section 2.3)

3.7 Question 8: Targets

40. We are supportive of the Government's draft regulations and Guidance in relation to targets and consider that the changes made to the proposals for performance monitoring are proportionate and meet the policy intent.

41. We would reiterate our view that the Government should go further, as soon as developments allow, in requiring that trustees set targets which align with the Paris Agreement and/or ITR, for the same reasons stated in section 3.6.

3.8 Question 9: Disclosing in line with the TCFD

42. We are supportive of the draft regulations and Guidance and consider that they meet the stated policy intent. We are particularly supportive of the suggestion in the Guidance that the link to the published TCFD report included in the Annual Report is accompanied by a short summary. In our experience, members have struggled from a lack of transparency and engagement with their schemes on climate change issues. Clearly signposting the TCFD report and related documents will go some way to resolving some of these issues.

3.9 Question 10: Penalties

43. Overall, we are supportive of the draft regulations and Guidance and consider that they meet the stated policy intent at this time. The compliance and enforcement regime will be a key area for review in 2023 on the basis that certain requirements (such as the "as far as they are able" threshold) may evolve and to ensure that trustees are fully incentivised to fulfil all requirements adequately.

3.10 Question 11 (Impacts) and Question 12 (Any other comments)

44. We do not intend to intend to respond to question 11. Additional comments are provided in our comments in section 2 above.

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