ASSOCIATION OF PENSION LAWYERS
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Emma Walmsley, Tom Rhodes and David Farrar
Climate Change and Responsible Investment Team
By email to: pensions.governance@dwp.gov.uk

Dear Emma, Tom and David

Taking action on climate risk: improving governance and reporting by occupational pension schemes – Policy consultation response and Consultation on regulation (the "Consultation")

I am writing on behalf of the Investment and Defined Contribution Sub-Committee of the Association of Pension Lawyers of the United Kingdom ("**APL**"). The APL is a not-for-profit organisation whose members comprise over 1,100 UK lawyers, including most of the leading practitioners in the field, who specialise in providing legal advice on pensions to sponsors and trustees of pension funds and others, including the largest pension funds in the UK. Its purposes include promoting awareness of the role of law in the provision of pensions and to make representations to other organisations and governments on matters of interest to APL members.

The purpose of this letter is to set out our responses to a number of the questions asked in the Consultation (and we do not answer all questions). As is usual, we do not comment on issues of policy other than where we do not think your proposals achieve your stated policy aim.

Question 1

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?

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

We agree that the change in the reference date should give greater certainty to schemes in order to allow them to identify more clearly whether they will be in scope of the regulations at an earlier stage. We are supportive of this change. Additionally, we welcome the removal of the 31 December reporting "long-stop" deadline, allowing schemes a common reporting deadline of seven months from the end of the relevant scheme year. For schemes with a 31 September year end this will be a particularly welcome change given the previous deadlines for reporting would have been too tight (although please see the response to Question 5(a) below).

Relevant asset threshold and 'Relevant Contracts of Insurance

We note that following the original consultation, a policy decision has been made to exclude 'buy-in' insurance contracts held by a pension scheme from the relevant asset threshold that determines whether (and when) a scheme is in scope for this regime.

However, it appears that a policy decision has been made:

- that while buy-ins are excluded from the relevant asset class that determines scope, they will not be excluded from the assets over which scenario analysis will be required; and
- other investment classes over which the trustee i) other than in very limited circumstances cannot withdraw from the investment and ii) the trustee has no control over the underlying investment, have not been excluded from the relevant asset definition (or included in the definition of relevant contract of insurance).

Taking each of these in turn:

Scenario analysis and reporting: To the extent that you have excluded buy-ins from the relevant assets that determine scope, on the basis that the trustees cannot unwind the contract and have no control over the underlying investment policy of the insurer – then in our view that logic should also extend to the trustees' scenario analysis and reporting requirements (once the scheme is in scope), and these assets should be excluded from that aspect of the new regime.

In our view, to the extent that analysis and reporting requirements should apply, they should be imposed on the insurers (or on the trustee only prior to entering into the buy-in contract / or contracts entered into after this new regime comes into force).

Other asset types: Again, to the extent that the DWP has accepted the logic of excluding buy-ins from the relevant assets that determine scope, then in our view other analogous transactions should also be excluded. For example, longevity transactions cannot generally be unwound and again a trustee will not have control over the insurers' investment policy. Ultimately, there is very little a trustee can do once a transaction that shares these attributes is in put in place, and in our view this would be better as a requirement when evaluating the investment before it is implemented.

We should be happy to assist in the drafting of any changes to the draft regulations, should the DWP decide that it would like to accommodate these changes.

Relevant Contract of Insurance

The definition of Relevant Contract of Insurance is used to exclude buy-ins from a scheme's relevant assets. We have two comments in respect of that definition:

"**In all circumstances**": As a part of a buy-in, an insurer will not, generally, insure the benefits of the scheme as set out in its trust deed and rules. Rather it will insure what is set out in a benefit schedule/specification provided by the trustee and then attached to the contract (in return for a specified premium). This can differ from the scheme benefits (for example, where some specific benefits cannot be insured) and, even where it is intended to mirror the trust deed and rules, it will generally not cover those benefits "in all circumstances". For example, in the latter case, insurers will not have taken the risk of GMP equalisation – so it cannot be said that when the trustees entered into the contract it was "*intended **in all circumstances** to fully meet the cost of specified benefits"*

In our view, the words "*in all circumstances to fully"* should be removed and replaced simply by the word *"to".*

Discretion over investment policy: We understand that this is a key policy element of excluding buy-ins from the scope. However, there are some circumstances where in a buy-in contract collateral is required to be posted by the insurer, and the contract will specify that these assets can only be of a specific 'quality' or type (and so the insurance company arguably does not have "*full and ongoing discretion over the investment policy*"). In some circumstances, where that collateral is required to be called upon (notably insurer default), that collateral will be "*used to meet* [the insurers'] *liabilities to make payments under the contract"*.

Although relatively rare, these provisions are more likely to be included in larger transactions. In our view, this issue could be remedied by excluding collateral arrangements explicitly: by including the words "*(except in respect of any collateral arrangements)*" after "*assets*".

<u>Question 3:</u>

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

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

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

We understand that the policy intention is that trustees satisfy themselves that people managing the scheme (now split into two in the draft regulations) are identifying risks and opportunity arising from climate change. In our response to the original consultation we set out our concern that this definition was too wide – and would catch individuals that have no responsibility or involvement with issues that relate to climate change.

While we welcome the split contained in the draft regulations, we are still concerned that the provisions dealing with persons who undertake governance activities in respect of the scheme are too wide (and not limited by the statutory guidance). In our experience, there are many schemes that employ individuals for specific tasks that, while they still amount to governance activities, have no relevance to climate related risk. For example, IDRP administration or minute taking and production.

This risk is mitigated in the second limb of Paragraph 2 of the Schedule (dealing with advisers) – as it only requires them to take "*adequate steps to identify and assess climate-related risks and opportunities* ***which are relevant to the matters in respect of which they***

are advising or assisting". In our view, it would be worthwhile including similar wording in the first limb.

<u>Question 5</u>

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?

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

We think that some clarity needs to be brought (either in the regulations or the statutory guidance) as to the meaning of the term "undertake" in paragraphs 6, 8, 9 and 10 of Part 1 of the Schedule to the draft regulations for the purposes of the requirement to undertake scenario analysis in the first scheme year to which the requirements apply.

Taking a scheme with a compliance start date of 1 October 2021 and a scheme year-end date of, say, 31 March 2022, there may be considered to be at least three possible interpretations:

1. the trustees must "complete" the analysis (ie have the results finalised) before 31 March 2022 but the "as at date" they use as their reference point could precede 1 October 2021 (eg the trustees might base the scenario analysis on scheme assets/liabilities as at 31 March 2021);

2. the trustees must complete the analysis before 31 March and using an "as at" date falling within the period (eg based on assets/liabilities as at, say, 31 December 2021);

3. the trustees must use an "as at" date falling within the period (eg based on assets/liabilities as at, say, 31 March 2022) but the results need not be completed until after the year end. For example, the "write-up" of the scenario analysis might form part of the trustees' reporting to be disclosed by October 2022.

Whilst we think that the first interpretation may be the most natural reading of the draft regulations as they stand, we think there is merit in the third interpretation, which would ensure that the reporting is as up-to-date as possible.

There is a further matter to consider in relation to permitting flexibility for trustees to align their activities with voluntary reporting which many larger schemes have committed to. For example, PRI has an annual reporting "season" for investors in the first quarter of each calendar year.

In order to allow maximum flexibility, the DWP may wish to consider simplifying the timing requirements so that the "outcome" of the scenario analysis must be included in the report required under regulation 3(1) (as per paragraphs g) and (h) of Part 2 of the Schedule to the draft regulations) but allowing trustees to select the "as at" date for the scenario analysis as the date which suits the scheme's circumstances the best. The regulations could specify that this must be no earlier than, say, 15 months prior to the year end to which the report relates. The regulations need not specify when the analysis is "undertaken" other than that it must be completed before the report.

As well as providing a more flexible approach to timing, the above approach would also allow schemes with a short first "year" (particularly schemes with a 31 December year-end) a little more time to comply with the new governance requirement. Further it can then be made clear that the "every three years" requirement relates to the report rather than the specific date the analysis was undertaken.

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.

We welcome the flexibility for trustees to select their own climate change metric in addition to the two required emissions-based metrics. For this purpose, the statutory guidance provides (at paragraph 134) a number of suggested non-emission based metrics. The guidance continues (at paragraph 137) that trustees should explain their choice of additional climate change metric.

Whilst this appears to provide some flexibility for trustees, we are concerned that it may stifle trustees' ability to identify the metrics that are most suitable to their scheme and the trustees' investment policies. For example, trustees may find it more beneficial to identify a metric based on their stewardship/engagement activities (which may be more suitable to trustees with a passively managed approach).

We are also aware that some schemes may also wish to use an emissions-based metric as their chosen "additional" climate change metric. For example, given current data quality issues with scope 3 reporting, we are aware that some trustees have considered monitoring (and setting targets by reference to) the Weighted Average Carbon Intensity (WACI) of their portfolio including only scope 1 and 2 emissions (ie excluding scope 3). Given current data gaps with scope 3, trustees may consider this to be a more reliable metric to set emissions reduction targets against for the time being, with performance against targets less susceptible to changes in assumptions.

In order to give trustees more flexibility, it may therefore be preferable to identify clearly in the statutory guidance that the suggested non-emission based metrics at paragraph 134 are suggestions rather than a shortlist of three additional metrics from which trustees must choose one. This might be achieved by replacing the word “should” with “may” at the start of paragraph 134 and making clear in paragraph 137 that trustees can choose alternative metrics.

<u>Question 8</u>

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.

It was helpful that the consultation confirmed that the requirement in the draft regulations for trustees to set at least one target to manage climate-related risks for one of the metrics calculated does not impose a legal requirement on trustees to set targets to reduce their absolute emissions or emissions intensity, or to set targets that are not achievable or that erode member value. The statements in paragraph 147 of the statutory guidance (that any target chosen by the trustees is purely for the management of material climate-related risks and opportunities and that trustees are not expected to align their own targets with other schemes’ or Governments’ targets) are similarly helpful.

In our view, paragraph 147 might usefully go further, in line with the consultation document and the PCRIG guidance, to emphasise that targets should be tailored according to their relevance to the scheme and should not conflict with trustees’ trusts law and fiduciary duties or the investment policies they have adopted in their statement of investment principles.

We should, of course, be delighted to discuss any the contents of this response in further depth should that be helpful. Please feel free to contact me (dominic.harris@cms-cmno.com), Stuart O’Brien (Stuart.OBrien@sackers.com) or Anna Copestake (Anna.Copestake@arcpensionslaw.com).

Yours sincerely

Dominic Harris
For and on behalf of the Association of Pension Lawyers