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The international business of Federated Hermes' response to the DWP consultation on Taking action on climate risk: improving governance and reporting by occupational pension schemes

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Our response

Question 1
We propose that the following schemes should be in scope of the mandatory climate governance and Task Force on Climate-related Financial Disclosures (TCFD) reporting requirements set out in this consultation:

a) *trust schemes with £1 billion or more in net assets*
b) *authorised master trusts*
c) *authorised schemes offering collective money purchase benefits*

Do you agree with our policy proposals?

We agree that these three categories are a strong place to start and that all three should be within scope. Coverage of just over 80% of the market is a positive step forward. Please see our answer to Question 3 regarding the expansion to smaller schemes.

Question 2

We propose that:

a) *trustees of schemes with £5 billion or more in net assets on their first scheme year end date to fall on or after 1 June 2020 are subject to the climate governance requirements from 1*

October 2021 and the trustees must publish a TCFD report within 7 months of the current scheme year end date or by 31 December 2022 if earlier

b) *trustees of schemes with £1 billion or more in net assets on the first scheme year end date to fall on or after 1 June 2021 are subject to the climate governance requirements from 1 October 2022, and the trustees must publish a TCFD report within 7 months of the current scheme year end date, or by 31 December 2023 if earlier*

c) *trustees of master trust or collective money purchase schemes which are authorised on 1 October 2021 are subject to the climate governance requirements with immediate effect, and the trustees must publish a TCFD report in line within 7 months of the current scheme year end date, or by 31 December 2022*

After 1 October 2021:

d) *trustees of master trust or collective money purchase schemes which become authorised are subject to the climate governance requirements with immediate effect, and the trustees must publish a TCFD report within 7 months of the current scheme year end date*

e) *where schemes cease to require authorisation, the climate governance and TCFD-aligned reporting requirements fall away with immediate effect, unless they remain in scope via the asset threshold on the previous scheme year end date*

From 1 June 2022 onward:

f) *trustees of schemes not already in scope of the requirements and with £1 billion or more in net assets on any subsequent scheme year end date:*
   - *are subject to the climate governance requirements starting from one year after the scheme year end date on which the £1 billion asset threshold was met*
   - *must publish a TCFD report within 7 months of the end of the scheme year from which the climate governance requirements apply*

g) *trustees of schemes in scope of the requirements whose net assets fall below £500m on any subsequent scheme year end date cease to be subject to the climate governance requirements with immediate effect (unless they are an authorised scheme) but must still publish their TCFD report for the scheme year which has just ended within 7 months of the scheme year end date*

Do you agree with the policy proposals?

We agree with proposals 2a), b) and c). As the DWP notes, all pension schemes should be considering ESG factors including climate change as part of their fiduciary duties. It is important to emphasise to all schemes that integration of climate risk into governance, strategy and risk management processes should already be underway, regardless of disclosure requirements, due to the nature and likely materiality of the risks posed by climate change. Furthermore, comprehensive and best practice TCFD reporting may take a couple of years of experimentation, and so it is key for as many schemes as possible to start now. We therefore agree with the proposal to encourage trustees of schemes with £1-5 billion in assets to begin work during the preceding year to ensure they are prepared for the governance and reporting requirements to become legally binding.

We agree with proposals d) and e) (with a similar recommendation that trustees who have the potential to fall into scope are encouraged to begin preparations to comply with governance requirements so that they can comply as soon as possible after the scheme year end date, rather than taking the whole year). We support proposals f) and g), and agree that the approach taken in g) is the best solution to the challenges outlined in the consultation paper regarding schemes falling below the threshold. It means that firms falling just below £1 billion will maintain a good standard of climate governance, which can only be a positive and is in line with our view that the requirements should eventually be extended to smaller schemes.

Question 3

Subject to Government deciding to adopt any of the governance or reporting requirements proposed in this consultation, we propose to conduct a review in 2024 on whether to extend the measures to schemes with below £1 billion in net assets which are not authorised master trusts or an authorised scheme offering collective money purchase benefits, and if so how and on what timescale.

This review would be informed by consideration of TCFD disclosures by occupational pension schemes to-date, their impact, and the availability and quality of both free and paid-for tools and services.

We would propose also to review any regulations and statutory guidance which had been put in place to identify whether any of this needs to be strengthened or updated.

Do you agree with these proposals?

Given the materiality of climate change for all pension schemes noted in the consultation Chapter 1, we would strongly advise that all pension schemes are encouraged to disclose in line with TCFD recommendations – or at least to begin the journey of integrating climate risk into risk management processes and strategy, supported by the appropriate governance - immediately. As the DWP notes, all pension schemes should be considering ESG factors including climate change as part of their duties, regardless of disclosure requirements. Over time as basic expectations increase and data and tools/experience with tools become more widely available we would expect even the smaller pension schemes to be able to disclose in line with TCFD, which would provide useful information to beneficiaries. The proposed review would therefore be welcome, and we would encourage the approach to be seeking to extend the requirements to smaller schemes unless there was clear evidence that this would be unfeasible.

Question 4

We propose that regulations require trustees to:

- *a) adopt and maintain oversight of climate risks and opportunities*
- *b) establish and maintain processes by which trustees, on an ongoing basis, satisfy themselves that persons managing the scheme, are assessing and managing climate-related risks and opportunities.*

We also propose that regulations require trustees to describe:

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c) *the role of trustees in ensuring oversight of climate-related risks and opportunities*
d) *the role of those managing the scheme in assessing and managing climate-related risks and opportunities, only insofar as this relates to the scheme itself and the processes by which trustees satisfy themselves that this is being done*

We propose that statutory guidance will cover the matters in the box above.

Do you agree with these proposals?

Yes, we agree. In addition to the areas already mentioned in Box 2, it is important that disclosures under the statutory guidance include whether there is a board-approved multi-year implementation plan in place and how the board oversees progress against climate-related metrics and targets.

In terms of the role of those managing the scheme, in addition to the areas already mentioned, the disclosures should include how outcomes from risk monitoring feed by these roles into board-level decision making and adjustments to risk frameworks, policies and financial planning.

Question 5

We propose that regulations require trustees to identify and disclose the climate change risks and opportunities relevant to their scheme over the short, medium and long term, and to assess and describe their impact on their investment and funding strategy.

We propose statutory guidance will cover the matters outlined in the box above.

Do you agree with these proposals?

Yes, we agree. Formalising climate change strategies, commitments or guidelines can help articulate and clarify expectations and outline how they will be achieved.

Question 6

We propose that regulations require trustees to assess the resilience of their assets, liabilities and investment strategy and, in the case of defined benefit (DB), funding strategy, as far as they are able, in at least two climate-related scenarios, one of which must be a 2°C or lower scenario and to disclose the results of this assessment.

We propose statutory guidance will cover the matters outlined in the box above.

Do you agree with these proposals?

Yes, we agree and strongly support the use of a below 2°C scenario in line with the Paris Agreement. We would support the use of a 1.5°C scenario once credible options are readily available. The DWP may wish to consider engaging with the relevant parties to help achieve this. Given that there are an increasing number of free resources available, it is reasonable to expect trustees to assess resilience in two climate-related scenarios and it should enable trustees to make more informed decisions.

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Given the long-term nature of many pension schemes' needs this is of great importance. Disclosure in the report of a description of the resilience of the organisation's strategy to climate change (informed by the risk management analysis) is an important exercise.

We strongly support the view that trustees should not wait for 'perfect' data as by the time this arrives it will be too late to tackle climate risk, and that scenario analysis and metrics that focus on available data or use estimated data are acceptable at this stage. We agree that trustees should request data from asset managers and make reasonable efforts to obtain data and we advise that they should encourage their asset managers (internal or external) to engage with assets for better disclosure if access to the underlying data needed is an issue. But in the meantime, as the DWP proposes, they can get started with what is available. Encouragement should be given to move from qualitative to quantitative scenario analysis wherever possible.

Disclosures around scenario analysis should include, in addition to the proposals in Box 6, the use of macroeconomic vs asset level scenarios, the key assumptions used in such scenarios (including for existing scenario and scenario analysis tools) and whether there is a uniform application across assets of scenario analysis (including how the outputs are used) or, if not, the scope of the scenario analysis. In addition to disclosing how the process and outputs of scenario analysis inform trustees' understanding of the impact of climate-related risks and opportunities, the results themselves should also be disclosed to provide members of the scheme with a 'heatmap' of the potential climate-related risks the scheme faces.

Question 7

We propose that regulations require trustees to:

- *a) adopt and maintain processes for identification, assessment and management of climate-related risks*
- *b) integrate the processes described in a) within the scheme's overall risk management*

We also propose the regulations require trustees to disclose:

- *c) the processes outlined in part a) above*

We propose statutory guidance will cover the matters outlined in the box above.

Do you agree with these proposals?

Yes, we agree. The process outlined in b) should also be included in disclosures.

We agree with the proposal to include the list from the final TCFD report of types of risk and opportunities in the statutory guidance. Detailed guidance should be provided where possible to help trustees understand what it means in practice to effectively identify, assess and manage climate change-related financial risks and opportunities. Disclosures should also explain whether the same process is applied uniformly across assets or whether there are variations. It is important that beneficiaries receive sufficient information to understand how trustees have managed and mitigated the risks identified in practice, rather than a high-level or boilerplated statement.

Any efforts to mitigate market-wide systemic risk should be included, for example advocacy to change the market framework and engagement with investee companies (either directly or via asset managers or service providers) should be disclosed. Such efforts can be collaborative or bilateral.

Trustees may also include the scheme's operational risk management process, including operational emissions, in order to cover all scopes of their climate risk and impacts.

Question 8

We propose that regulations require trustees to:

- a) *select at least one greenhouse gas (GHG) emissions-based metric and at least one non-emissions-based metric to assess the scheme's assets against climate-related risks and opportunities and review the selection on an ongoing basis*
- b) *obtain the Scope 1, 2 and 3 GHG emissions of the portfolio, and other non-emissions-based data, as far as they are able*
- c) *calculate and disclose metrics (including at least one emissions-based metric and at least one non-emissions-based metric) used to quantify the effects of climate change on the scheme and assess climate-related risks and opportunities*

We also propose in regulations that trustees be required to disclose:

- d) *why the emissions data that is estimated does not cover all asset classes, if this is the case*

We propose that trustees will not be mandated to use a specific measure to assess the effects of climate change on the scheme's portfolio.

We propose statutory guidance will cover the matters outlined in the box above.

Do you agree with these proposals?

We agree with the proposal to include at least one GHG emissions-based metric and at least one non-emissions-based metric, and for the default to be Weighted Average Carbon Intensity (WACI) including Scope 3 where possible. We also support the decision to mandate disclosure as far as trustees are able rather than to take a 'comply or explain' approach, and to require an explanation of any missing or estimated data in the disclosures. This is important context for the users of such disclosures, whilst encouraging disclosure of the data that is available. The list of matters to be included in the statutory guidance to which trustees must have regard covers a number of important areas, including how performance metrics are incorporated into remuneration policies.

Over time the number of metrics disclosed by schemes should increase. The DWP may wish to consider setting a timeline for stepped increases in the minimum requirement, or alternatively could explicitly add this as a factor to be considered in the 2024 review. Similarly, the 2024 review may wish to consider creating more consistency in the metrics and methodologies used once industry practice has further evolved. The FCA-PRA Climate Financial Risk Forum outputs may be of use in this exercise – notably the Risk Management and Disclosure Chapters - as well as in identifying a suggested list of metrics for the statutory guidance. In particular, calculation and disclosure of the warming potential of assets is advisable as a 'stretch target' for schemes to work towards (probably through requiring their asset managers to provide it), as well as a calculation of 'earnings at risk' based on scenario analysis.

Question 9

We propose that regulations require trustees to:

a) *set at least one target to manage climate-related risks for one of the metrics trustees have chosen to calculate, and to disclose those targets(s)*
b) *calculate performance against those targets as far as trustees are able and disclose that performance*

We propose statutory guidance will cover the matters outlined in the box above.

Do you agree with these proposals?

Yes, we agree with these proposals. As in our response to Question 8, over time pension schemes should set targets for additional metrics. These expectations could either be set out now to increase over time or considered in the 2024 review.

Question 10

We propose that, for all schemes in scope:

a) *the trustees should be required to publish their TCFD report in full on a publicly available website where the report is accessible free of charge*
b) *the trustees should be required to include in the Annual Report and Accounts a website link to the location where the full TCFD report may be accessed in full*
c) *the trustees must notify all members to whom they must send the annual benefit statement of the website address where they can locate the full TCFD report – this must be set out in the annual benefit statement*
d) *the trustees should be required to report the location of their published TCFD report to the Regulator by including the corresponding website address in their scheme return*
e) *the trustees should also be required to report the location of their published Statement of Investment Principles (SIP), Implementation Statement and excerpts of the Chair's Statement by including the corresponding website address or addresses in their scheme return*

Do you agree with these proposals?
Is there a better way to notify members of where to find this information?

For example, for DB schemes, might the summary funding statement required by regulation 15 of the Disclosure Regulations be a more appropriate way to signpost members to this information?

Yes, we agree with these proposals.

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Question 11

We propose that:

a) *The Pensions Regulator (TPR) will have the power to administer discretionary penalties for TCFD reports they deem to be inadequate in meeting the requirements in the regulations*
b) *there will be no duty on TPR to issue a mandatory penalty, except in instances of total non-compliance where no TCFD report is published*
c) *in all other respects, we propose to model the compliance measures on the existing penalty regime set out in regulations 26 to 33 of the Occupational Pension Schemes (Charges and Governance) Regulations 2015*
d) *failure to notify members via the Annual Benefit Statement or to include a link to the TCFD report from the Annual Report will be subject to the existing penalty regime set out in regulation 5 of the Disclosure Regulations*

Do you agree with this approach?

Whilst we understand that some penalties would be incurred (paragraphs 2 and 3 of Chapter 5 of the consultation paper) as part of the existing regime, we would be concerned about implications for members for example if it reduces the scheme's budget for TCFD disclosure the following year. A preferable approach would be to rely on transparency as an incentive. For example, schemes could be required to include a prominent statement on the benefit statement that they have breached regulation by failing to implement TCFD regulations in line with their legal requirements. If such measures failed, then fines could be considered. This at least would ensure beneficiaries are well aware of the situation and can then push for action. If a penalty regime is instituted, we agree that mandatory penalties should be limited to instances of total non-compliance.

Question 12

Do you have any comments on the new regulatory burdens to business and benefits, and wider non-monetised impacts we have estimated and discussed in the draft impact assessment?

We are extremely supportive of the proposals. As regulatory discussions evolve both in the UK and globally this is a very important and positive leadership development from the DWP. Climate change risks are material, and in the interest of scheme members it is crucial to start managing the risk now or the impacts will be far greater further down the road. We know from having published our own TCFD report that the process of doing so helps to focus minds internally on what the next steps need to be, so there is huge value in beginning that process early.

Question 13

Do you have:

a) *any comments on the impact of our proposals on protected groups and how any negative effects may be mitigated?*
b) *any evidence on existing provision made by trustees in response to requests for information in alternative accessible formats*
c) *any other comments about any of our proposals?*

As an encouragement to schemes to start early – in a similar approach to that taken by the FRC in providing feedback on draft 2020 Stewardship Code reports – the DWP may wish to consider providing feedback to those who report early and/or sharing best practice from the first round of reporting. This will help to raise disclosure standards across the board.