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Dear Bethan, Tom, Andrew and David

Taking action on climate risk: improving governance and reporting by occupational pension schemes

We welcome the opportunity to respond to the Department for Work and Pension (DWP) consultation: *Taking action on climate risk: improving governance and reporting by occupational pension schemes.*

As the Government recognises, these proposals come as trustees are dealing with the impact of the COVID-19 pandemic. However, we recognise the need for the Government to act now to ensure that pension scheme governance is as robust as possible, to withstand the potential shocks that climate change, and the response to it, will bring.

Pension funds form a vital part of the financial ecosystem, with an import role to play in financing both a green recovery and the transition to Net Zero. As asset owners, pension funds are also able to exercise their stewardship responsibilities[1] to influence investee companies to transition their business models and business practices. We therefore support the DWP's proposals to require pension schemes to produce Taskforce for Climate-related Financial Disclosure (TCFD) aligned disclosures. Our more detailed responses to the specific consultation questions are set out in Appendix I.

We believe that phasing in the requirements, initially for larger schemes, is a robust and proportionate approach and we welcome the clear roadmap set out for smaller schemes. We believe that only by mandating TCFD will we observe positive changes within pension schemes' governance processes in relation to climate change. We would also encourage these TCFD proposals to go alongside the wider DWP policy objective of Net Zero carbon emissions, which we also support.

[1] See the EY report Meeting great expectations Analysis and insights of stewardship engagement and outcomes for asset owners https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/assurance/stewardship-asset-owners-insurance.pdf

We hope that you will find our response helpful. Please do not hesitate to contact us if you would like any further information or wish to discuss any points in more detail.

Yours sincerely

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APPENDIX I – Responses to consultation questions

Q1. We propose that the following schemes should be in scope of the mandatory climate governance and TCFD reporting requirements set out in this consultation:

a) trust schemes with £1bn or more in net assets

b) authorised master trusts

c) authorised schemes offering collective money purchase benefits

Do you agree with our policy proposals?

Yes, we agree with these proposals. We think that a proportionate approach should be taken, whereby larger schemes are required to produce TCFD disclosures in first instance.

We welcome the proposed inclusion of defined benefit, defined contribution and hybrid schemes within the scope of the TCFD regulatory requirements. To the extent that an authorisation framework will be set up for super funds, and the transactional activity will become significant, we would also expect super funds to be subject to TCFD reporting requirements.

We consider the proposal to not include a size threshold for authorised master trusts to be reasonable for the following reasons:

- a large proportion of authorised master trusts have assets of over £1bn and we expect that assets under management will continue to grow
- as all master trusts are subject to the same authorisation framework, we would expect them to be subject to consistent regulatory requirements. Pension scheme trustees that are in the process of selecting a master trust should not use the regulatory requirements the master trust is subject to as a factor in their decision-making process

Q2. We propose that

a) trustees of schemes with £5bn 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 £1bn 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 £1bn 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 £1bn asset threshold was met; and**
- **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?

Yes, we agree with these policy proposals and consider that the in-scope schemes will be given sufficient time to prepare for reporting in line with TCFD requirements. We note that the timeline is tighter than for other similar companies (e.g. insurers) who are not already covered by the UNPRI mandatory requirements, and we acknowledge and encourage DWP's ambition to mandate the TCFD requirements for pension schemes.

We also have the following comments:

► Allowing trustees of schemes with £1bn or more in net assets, but less than £5bn, an additional year to prepare for implementing the policy proposals is aligned with the Government's overall proportionate approach to embed TCFD into reporting requirements. However, in most cases, we do not consider the governance budget and resources to be significantly different for schemes within this size bracket and schemes with £5bn or more in net assets. As such, we would expect all schemes with £1bn or more in net assets to be able to work towards compliance with TCFD within the same timeline. In our view, a better indicator of a scheme's governance budget could be the investment governance framework that is currently adopted or the existence of any in-house pensions/investment team, as opposed to the size of assets under management.

- We welcome the proposal that schemes which subsequently breach the asset threshold over time will be subject to the climate governance and TCFD reporting requirements.
- As the Government proposes that a further review will be conducted in 2024 to determine whether climate governance and TCFD requirements will be applicable to schemes with below £1bn in net assets, we do not consider it necessary to prescribe a size threshold to determine circumstances when the current in-scope schemes would be exempt from TCFD reporting requirements at this stage.
- We acknowledge the clarification that insurance contracts secured by pension schemes do not count towards the TCFD threshold requirements. We would expect this to mean that pension schemes will need to more explicitly cover TCFD and net-zero alignment of the insurance company that is issuing the policy (i.e. either buy-in or buy-out). We would also expect collateralised buy-ins to require a similar treatment as the net assets, if they exceed £1bn. We would welcome further confirmation on these points.

Q3. 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 £1bn 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?

We support the Government's proposal to perform a subsequent review to determine whether schemes with below £1bn in net assets should be subject to these requirements. However, conducting this review in 2024 may imply that schemes with below £1bn in net assets would not have to be compliant with climate governance and TCFD reporting requirements until 2025 or 2026 (if they will be working towards a similar timeline as the currently in-scope schemes). In our view, the Government should encourage smaller schemes to take steps towards climate change governance and TCFD reporting in the period leading up to the 2024 review.

An option could be to require smaller schemes to adopt a proportionate approach to addressing climate change risks relative to the complexity of their investment strategy or liability profile (i.e. fewer requirements than the larger schemes are subject to). If this is the case, smaller schemes may be required to publish TCFD reports from an earlier date. Increased regulatory requirements on smaller pension schemes may accelerate pension scheme consolidation activity over the next few years.

Q4. We propose that regulations require trustees to:

a) adopt and maintain oversight of climate risks and opportunities, and

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:

c) **the role of trustees in ensuring oversight of climate-related risks and opportunities; and**

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 believe the above proposals are sensible, subject to the suggestions detailed below:

- ► Proposals a) and b) will require trustees to put in place explicit processes to manage climate related risks (including sponsor covenant risks) and opportunities on an "ongoing basis". In our opinion, it would be beneficial to set out in regulations the minimum frequency trustees should carry out a formal review of their processes and the oversight of parties involved in managing the scheme.
- ► We support the requirement for statutory guidance to support trustees in complying with their duties and to ensure a consistent and comparable approach is taken across pension schemes. Guidance would also help provide expectations on the level of detail trustees should disclose and set out what may be considered best practice.
- ► We welcome the points included in the statutory guidance, as defined in the box above. We expect implementing TCFD to be viewed as an onerous exercise by some trustees, and we acknowledge that trustees may require further guidance on how to interact with their asset managers or advisors. Particularly, we think trustees would find the following useful:
    - ► Clarification of any requirements on asset managers (where relevant) to support with disclosures
    - ► Clarification and guidance on how trustees could identify and understand if their advisors have the necessary skills to advise on TCFD-related matters

Q5. 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 with these proposals. This is a new area for schemes and whilst some larger schemes have progressed significantly with embedding a strategic approach to climate change in their scheme strategy, there is complexity and nuance in climate change risk analysis, indicating a need to go beyond principles-based regulation and to support schemes with relatively prescriptive 'de minimis' standards, covering the areas described in the box. The scheme's sponsor will also be subject to climate change risks and hence we believe sponsor covenant risks should be considered as well.

In particular, EY supports the requirement to carry out an analysis of different timescales covering the orderly, dis-orderly and hothouse scenarios. There is a danger that climate change risks are seen as distant, whereas we would support a 2025 disorderly scenario requirement, similar to the thinking used in the Principles of Responsible Investment's Inevitable Policy Response. This recognises that disruption may not be linear and may be accelerated by abrupt policy shifts, such as the recent announcement on carbon neutrality from China. Similar non-linear disruption could come from technology and/or changing markets. EY has, for example, published information[2] on non-linear energy transition tipping points occurring before 2025.

There is also a rapidly increasing physical risk environment, which will increase over time, that we have written about in our recent Megatrends report. In our view, the range of scenarios proposed by The Pensions Regulator should recognise that the level of physical risk is increasing more rapidly than previously expected.

Q6. We propose that regulations require trustees to assess the resilience of their assets, liabilities and investment strategy and, in the case of 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 with the proposals although, as discussed below, we note that this could be very a onerous requirement for some schemes. There will be some combination of physical and transition risks in the future. The pace and scale of the transition will drive the physical risk level, the orderliness of the transition will drive the likely extent of market disruption. Therefore, schemes should assess their exposure to both of these risks and explore, via scenario analysis, how they would be impacted. As discussed in our response to Q5 above, we support the inclusion of an early (2025) disruptive scenario.

In addition to exploring possible climate scenarios, we think it is important for schemes to start to form a view on likely or at least more probable climate scenarios, to determine what strategy is most appropriate for them.

However, as the DWP recognizes, the data needed for scenario analysis is non-standard and there are no industry standard methodologies or tools available yet to process the scenarios. As you may be aware, in its Discussion Paper on *The 2021 biennial exploratory scenario on the financial risks from climate change,* the Bank of England proposed requiring participants (large banks and large insurers) to assess 80% of their corporate counterparties at counterparty level. Whilst an 80% counterparty level assessment threshold would help drive good risk management, it may be too high for some portfolios/firms. For example:

[2] https://www.ey.com/en_uk/digital/energycountdownclock.

- most schemes would not have the bandwidth to engage bilaterally with their counterparties to gather the necessary information outside of their BAU engagement with them, potentially limiting the quality of information and engagement on the topic within the industry
- counterparties with multiple material business relationships may not have the bandwidth to engage with their investors to provide the information requested

It would, therefore, be helpful if the guidance to trustees could discuss expectations regarding data and methodologies, to avoid the risk that trustees may feel compelled to buy datasets that might not capture the real risks, and how the percentage of coverage could be set by sectors and geographies, based on expected impacts materiality, thus avoiding both a one-size-fits-all limit and the risk of arbitrary coverage if set by individual schemes.

Additionally, a DB scheme's funding strategy is often reliant on the scheme's sponsor covenant paying contributions, and/or continuing to be a going concern. As the scheme's sponsor will also be subject to climate change risks, Trustees should be explicitly required to understand the extent of current and future potential reliance on the sponsor covenant and on the climate risks the sponsor covenant is exposed to.

Q7. 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 welcome the risk management proposals, and believe that pension scheme Trustees should have a robust approach for integrating climate risk in their wider pension scheme risk management framework.

Requiring trustees to disclose their processes for the identification, assessment and management of climate-related risks as part of TCFD reporting is appropriate. However, given the complexity of this area, we believe that there is a risk that the information disclosed will be largely theoretical, ambiguous and generic and as such, precise guidance would have to be provided in terms of the type and format of the information trustees should be disclosing.

More importantly, we believe that the statutory guidance should discuss the interaction between Trustees and asset managers, investment consultants, fiduciary managers and the scheme sponsors in determining the processes for addressing climate related risks. In our view, Trustees must be able to critically challenge the information received from specialists with regards to climate change risks and must work together with their advisors on embedding climate-related risk within the pension scheme's overall risk management.

Q8. We propose that regulations require trustees to:

a) Select at least one 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?

Yes, we agree with these proposals. We expect data, systems, tools and methodologies to continue to improve rapidly in this space, including the emergence of standardised and comparable reporting of GHG emissions across scope 1, 2 and 3. The lack of consistency today should not be a barrier for taking action though, as there are enough solutions available to the market now to start to make better decisions to both manage risk and increase alignment.

As a professional services firm, we apply a range of methodologies, depending on the requirements of our clients, to calculate financed/avoided emissions. These include (either exclusively or in combination), but are not limited to:

- PCAF
- The GIB-Foundation Green Impact methodology
- Client-specific methodologies, which build on the World Resources Institute (WRI) guidance for estimating and reporting on comparative emissions impacts

In practical terms, schemes are likely to require metrics both around financial risk and opportunity (e.g., impact on scheme funding position in different climate scenarios, impact on these results of different investment strategies) and non-financial (e.g., weighted average carbon intensity, absolute carbon emissions). Although risk and alignment metrics may differ, they are likely to be closely related, for example, high carbon companies are also likely to be a reasonable proxy for areas of transition risk in asset portfolios.

We believe it would be useful for DC schemes to report the metrics at a fund level, as well as at an overall scheme level. Given members are likely to have a choice to invest in different funds, the information at a fund level will be more useful to their personal investment decisions than information on the metrics at an aggregated level.

Q9. 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.

Q10. 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?

We agree with the proposals above and have following, additional comments:

- We welcome the requirements to report the location of the TCFD report within the Annual Report and Accounts, annual benefit statement, scheme return and SIP.
- We do not think that the information produced as part of TCFD reporting is targeted at members. Whilst there will be a link to the TCFD report included in the members' annual benefit statement, a large part of the information included in the report is not directly relevant to members. We think that additional bespoke reporting will need to be provided to members – this could take the form of separate comprehensible communication explaining the actions taken by trustees to ensure TCFD compliance and additional background information. In general, we believe that members of DB schemes may often be more interested in understanding whether (and if so how) any of the actions taken by trustees as a result of

TCFD compliance will impact their pension benefits, and, hence, may be less interested in how climate change risk has been integrated in the wider risk management framework of the pensions scheme. However, DC members on the other hand have some discretion (within the funds available to them) over how their assets are invested and, therefore, may wish to receive information that could inform their investment decision-making.

► We agree that including a link to the TCFD report in the summary funding statement via regulation 15 of the Disclosure Regulations would be a helpful approach to signpost the location of this report. However, as discussed above, the content may not be directly relevant to members. We think that bespoke communication on climate change should be provided to members - this should be largely non-technical and discuss any implications to members' pensions.

Q11. We propose that:

a) 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?

Yes, we agree with the proposed approach to non-compliance.

Q12 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?

In our view, the impact assessment provides a useful, granular breakdown of the related costs and benefits that are associated with complying with climate change governance and TCFD reporting requirements. We consider the breakdown of the expected costs into the required activities (i.e. familiarisation, governance, strategy, scenario analysis, risk management, metrics, targets, reporting) to be particularly comprehensive and insightful for pension scheme trustees. In addition, trustees are somewhat guided on the various steps they need to take to ensure compliance.

However, we think that the impact assessment places a significant emphasis on costs. Whilst benefits are discussed qualitatively, and they have not been monetised and we believe it would be useful if the potential benefits are set out at the beginning of the document (within the Summary section) and presented within a visually impactful format.

We note the DWP's estimated ongoing costs of £15k per annum to schemes of carrying out climate change related risk analysis and reporting on this. In our experience, this cost feels very low and the implementation cost in particular is likely to be significantly higher for schemes who have not yet begun their work in this area.

Q13. 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?

We note and support the Government's intention to consult on the alignment of in-scope schemes to the policy objective of Net Zero carbon emissions in the short term. Reducing the financed emissions of UK pension schemes in line with the goals of the Paris Agreement is critical to achieving Net Zero, and this is an important area for institutional investors to support. We would highlight the Institutional Investor Group on Climate Change's draft methodology on how to implement a Net Zero investor framework as providing useful guidance in this area. We also note that a number of leading UK asset owners have now committed to Net Zero.