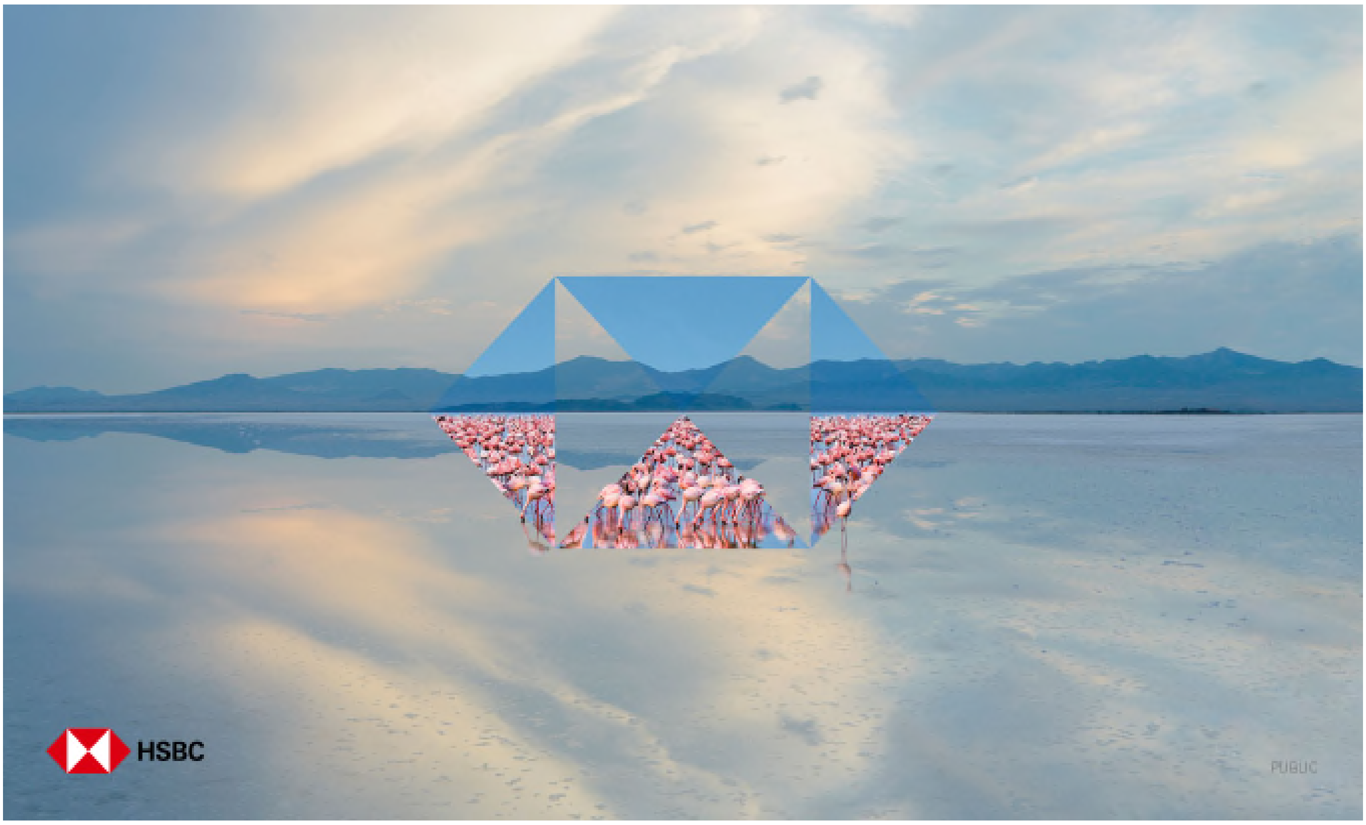
Taking action on climate risk: improving governance and reporting by occupational pension schemes



HSBC Bank Pension Trust (UK) Limited response

Introduction

- Overall, HSBC Bank Pension Trust (UK) Limited ('we') welcome the proposals set out in the consultation. We take the view this is a positive first step on the route to a lower carbon economy. We are keen to see a greater level of transparency of carbon data disclosure as this should, in turn, encourage positive action throughout the investment chain. We are hopeful that an end outcome of this activity is a marked decrease in carbon emissions and, in time, a low carbon world.
- We do, however, have limited concerns with some specifics in the proposals, namely:
  - Having produced a TCFD report per year for the past three years, we would stress that the effort, resources and time that goes into the preparation of a TCFD statement should not be under-estimated. We believe the proposed timing of the proposals is tight and we suggest that the proposal that regulation requires full compliance by December 2022 is revisited;
  - We are also keen that the statutory guidance does not risk causing material unintended consequences, such as a conflict of fiduciary and statutory obligations for trustees; and
  - Lastly, whilst we acknowledge that clear targets drive action, we have a concern that they can also drive a more mechanistic approach to compliance. It would be disappointing if such targets were predominantly met by mass disinvestment from companies with a higher carbon footprint rather than pro-active engagement with such companies to effect a reduction. Such an investment flight also has the potential to have a negative impact on funding and the value of member benefits.

Brian Kilpatrick

Brian Kilpatrick
Chief Investment Officer
HSBC Bank Pension Trust (UK) Limited
7 October 2020

Consultation questions and responses

Q1. The DWP propose that the following schemes should be in scope of the mandatory climate governance and TCFD reporting requirements set out in the 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 DWP's policy proposals?

◆ We have been working towards the TCFD reporting requirements for several years and, as a sizeable scheme, have been able to devote considerable effort and resource to this. We believe that we are therefore well positioned to comply with the reporting requirements. In the context of our experience, our view is that schemes with fewer resources, either due to size or structure, should be outside the regime until such time as the process has been bedded in and that a clear and robust guidance framework is in place for trustees of such schemes to consider.

Q2. The DWP 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 requirement 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?

- We are broadly welcoming of the proposals. However, we would caution that the proposals may risk under-estimating the complexity surrounding fully understanding and managing climate-related issues. By way of example the design of a default investment option for DC funds is a major decision point for trustees, given that the best investment options for DC members likely do not yet exist. Given this, to select one that adequately integrates the risks and opportunities associated with climate change is very challenging, particularly where trustees may need to manage potentially competing statutory and fiduciary duties. Thus, the policy proposals must remain mindful of unintended consequences in the form of hasty portfolio changes that may for example lower measurable carbon emissions but deliver lower investment return and so reduced retirement outcomes for members.
- We would be keen to see the development of detailed statutory guidance to support schemes to effectively adopt the TCFD recommendations and would suggest that this is a fundamental requirement prior to any consideration of extending the requirements to smaller, less well-resourced schemes.
- As we have previously indicated, our experience to date is that this is a complex area that requires considerable resource to fully and comprehensively implement. Where trustees have not yet begun the work to produce a TCFD statement and to collect the necessary data, we have concerns that aligning with the recommendations in full may well take more than the time proposed. We would therefore suggest that the proposal that regulation requires full compliance by December 2022 is revisited.

Q3. Subject to Government deciding to adopt any of the governance or reporting requirements proposed in the consultation, the DWP 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.

The DWP 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 agree that an effectiveness review should be carried out in 2024, as we strongly believe that industry collaboration is key to unlocking some of the challenges asset owners face. However, rather than simply focusing on whether to extend the requirements to a wider catchment of schemes, our preference would be that the review has a clear two-stage focus: firstly, to assess the extent to which in-scope schemes have successfully achieved compliance and the identification of any barriers, gaps and/or inconsistencies encountered, and secondly to consider extending the requirements. Only if the outcome of the first stage is positive should the review consider whether to broaden the catchment of in-scope schemes and the terms on which this might be done.

Q4. The DWP propose that regulations require trustees to:

a) adopt and maintain oversight of climate rights 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.

The DWP also propose that regulations require trustees to describe:

c) the role of the 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.

The DWP propose that statutory guidance will cover the matters in the box below.

BOX 2: Statutory Guidance on Governance
In meeting the requirement for trustees to maintain oversight of climate-related risks and opportunities, we propose that statutory guidance would outline the following matters to which trustees must have regard:

- The role of trustees as ultimately accountable for the scheme's handling of climate change-related risks and opportunities;
- Sufficient allocation of trustees' time and resources for assessing climate-related risks
- Integration of climate change into the scheme's existing governance processes, including the processes and frequency by which the trustees meet to discuss, and are informed about, climate-related issues
- In meeting the requirements to establish and maintain processes by which trustees satisfy themselves that the persons managing the scheme assess and manage climate-related risks, statutory guidance would set an expectation that this includes:
  - employees of the scheme;
  - employees of the principal or controlling employer;
  - external advisers who provide services to the trustees; and
  - scheme funder or strategist (in the case of a master trust)

Statutory guidance would outline the following matters to which trustees must have regard, in relation to the role of such persons and describing those roles in their TCFD report:

- Whether it is appropriate to assign climate-related responsibilities to external advisers, employees or committees within the management structure, and if so, what those responsibilities involve;
- How and when such positions or committees should report to the trustees;
- How trustees should describe/illustrate the structure of the scheme and the roles that such persons play in ensuring climate-related risks are managed; and
- The types of processes that trustees should put in place to ensure external advisers or employees of the principal or controlling employer to which management has been delegated, are informed about and monitor climate-related issues effectively.

Statutory guidance would also set out that trustees should describe, in their TCFD Report, how they have approached each of the matters above

Where they choose to deviate from the approach set out in the guidance, trustees would be expected to describe their reasons for doing so in the relevant section of their TCFD Report.

Do you agree with these proposals?

- We are supportive of the proposals set out in this question. We consider processes for ensuring oversight of climate-related risks and opportunities important and we believe that the proposals should help set the standard for good practice on climate-related governance and disclosure practices.
- We believe good governance in this area is key. We have taken the time to reach a clear, concise and well-defined set of beliefs concerning climate change. However, for schemes that have not invested so significantly the proposed timeline may be too short to enable trustees to gain the required expertise. As such, whilst we have no comment on the proposed topics to be covered in the guidance, we would stress the importance of having a sufficiently granular level of content to support trustees to make the complex disclosures required. The statutory guidance should also reflect that adopting new processes is challenging and takes time to do well.

Q5. The DWP 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

The DWP also propose statutory guidance will cover the matters outlined in the box below.

Box 4: Statutory Guidance on Strategy

In identifying and assessing the impact of climate-related risks and opportunities on the investment and, in the case of DB, funding strategy of the scheme over the short, medium and long-term, we propose statutory guidance would set out the following matters to which trustees must have regard:

- The levels at which the identification and assessment of risks and opportunities should be carried out - for example, the individual sections of a scheme with DC and DB sections - as well as additional analysis that could be carried out, for example, in relation to different asset classes;
- How to understand and assess the scheme's climate risks and opportunities across short, medium, and long-term time horizons;
- Examples of climate-related risks and opportunities that could have a material financial impact on scheme assets;
- Definitions to help trustees understand whether the climate-related risks are transition or physical risks;
- Examples of the factors trustees might consider to determine which risks and opportunities could have a material financial impact on their investment strategy and funding strategy; and
- Guidance on how climate-related risks and opportunities could be factored into their investment strategy and funding strategy and the implementation of those strategies.

Statutory guidance would also set out that trustees should describe in their TCFD Report how they have approached each of the matters above.

Where they choose to deviate from the approach set out in the guidance, trustees would be expected to describe the reasons for doing so in the relevant section of their TCFD Report.

Do you agree with these proposals?

- We agree that the risks posed by climate change are likely to manifest themselves differently over varying time horizons. The relative split between transition and physical risks will change in favour of physical risks the longer the observable time horizon. We believe it is possible to analyse these impacts at a portfolio/fund level which is required for a trustee to make a materiality assessment relative to the objective of paying members' benefits. We would urge against the statutory guidance requiring too granular assessments that are usually the responsibility of investment managers or advisers.
- The guidance should clarify that risk mitigation following assessment does not have to come in the form of divestment or portfolio changes. This may be too short term and promote further unintended consequences.
- In addition to this, very granular assessments of fund-specific risks should be avoided as this may require disclosure of confidential or market-sensitive information. We urge the guidance to pay due regard to the sometimes complex investment strategies of large pension schemes.
- We note the proposed requirements are based on a trustee's funding strategy in addition to the investment strategy. We believe these raises some additional considerations and we have outlined these in our response to question 6 below.

Q6. The DWP 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 degree C or lower scenario and to disclose the results of this assessment.

The DWP propose statutory guidance will cover the matters outlined in the box below.

Box 6: Statutory Guidance on Scenario Analysis

In assessing, as far as they are able, the resilience of the scheme's assets, liabilities and investment/funding strategy to climate-related risks and opportunities in at least two climate-related scenarios, we propose statutory guidance would set out the following matters to which trustees must have regard:

- The levels at which scenario analysis should be carried out - for example, the individual sections of a scheme with DC and DB sections, or the individual fund- level;
- How the trustees may approach the use of scenario analysis, whether qualitative or quantitative, to understand the resilience of the investment strategy, and where relevant, funding strategy, to climate-related risks and opportunities;
- How trustees should go about selecting scenarios most appropriate to their scheme's investment horizons including references to examples of existing scenarios and scenario analysis tools which are available to schemes;
- How trustees should approach external factors which limit their ability to do scenario analysis, such as data gaps, and what is expected of trustees in terms of undertaking scenario analysis 'as far as they are able'; and
- How to use the process and outputs of scenario analysis to inform trustees' understanding of the impact of climate-related risks and opportunities on the investment/funding strategy and examples of possible steps they could take to ensure their strategy addresses risks and opportunities.

Statutory guidance would also set out that trustees should describe, in their TCFD Report, how they have approached each of the matters above.

Where they choose to deviate from the approach set out in guidance, trustees would be expected to describe the reasons for doing so in the relevant section of their TCFD Report.

Do you agree with these proposals?

- We agree that scenario analysis can be a useful tool to carry out the risk assessment over the required short, medium, and long-term time horizon.
- The guidance should promote recognised industry practice for scenario analysis, for example that set by the Prudential Regulatory Authority and the Bank of England. The underlying assumptions and model detail can get highly complex, often with broadly the same conclusions as simpler methods. We therefore hope that the statutory guidance does not promote fundamental changes in investment strategy as a result of scenario analysis, which would present material model risk.
- The requirements to extend scenario analysis beyond the investment strategy to the funding strategy for DB schemes may also create additional layers of complexity. We understand funding strategy to be the interaction of the investment strategy, liability profile and sponsor covenant. For a trustee to carry out scenario analysis on the liability profile would require the scheme actuary to calibrate longevity and mortality assumptions to different climate pathways. We understand this is being considered by industry bodies including the IFoA and so would look to them to lead on this, however the impact of climate change scenarios on UK mortality is highly uncertain, but changes in parameters may have material impacts on the expected funding journey of a scheme.
- Any underlying assumptions that impact the actuary's assessment of the scheme's liabilities must go through comprehensive consultation and analysis between both the trustee and their advisers, and the

trustee and the corporate sponsor. This process happens every three years as part of the triennial actuarial valuation. Requiring this to happen every year would be overly burdensome.

- Finally, trustees retain the advice of a specialist to assess the strength of the covenant with the corporate sponsor. Generally, such advice is confidential and may be market sensitive. It would be inappropriate to require trustees to disclose material non-public information in the course of publishing the results of scenario analysis on the covenant strength. We suggest these two assessments could be included in guidance as part of the actuarial valuation and subject to a comply or explain approach in terms of disclosure if the results are sensitive.

Q7. The DWP 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.

The DWP 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 below.

Box 8: Statutory Guidance on Risk Management

With regard to processes for identifying and assessing climate-related risks, we propose that statutory guidance would set out the following matters to which trustees must have regard:

– The types of processes trustees should put in place in order to identify the climate-related risks that the scheme is exposed to, including emerging regulatory and supervisory requirements related to climate change (e.g. limits on emissions) as well as other relevant factors;
– The types of processes trustees should implement for assessing the potential size and scope of identified climate-related risks;
– How trustees should work with asset managers and others to ensure that identified risks are recognised and assessed by others in the investment chain.

Do you agree with these proposals?

- We agree with the proposal that the identification, assessment, and management of climate-related risks should be included in the existing risk management framework. However, we note that this integration process takes time, significant governance resource and trustee training.
- We believe there will be a wide disparity of approaches to doing this for different schemes. The statutory guidance should reflect this and not be overly prescriptive. Industry collaboration and the sharing of best practice is important. Public disclosure will facilitate the proliferation of good practices but we believe good case studies to base actions on from the outset will be important sources for the guidance.
- A benefit of building climate-related considerations into an existing framework is that materiality can be relatively assessed versus other risks the scheme faces, as climate change is not the only risk the scheme faces across different time horizons. The management and level of required disclosure should therefore be proportionate to the materiality of the risk to members' financial outcomes.

Q8. The DWP 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.

The DWP also propose in regulations that the trustees be required to disclose:

d) Why the emissions data that is estimated does not cover all asset classes, if this is the case.

The DWP 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 below.

Box 10: Statutory Guidance on Metrics

With regard to the proposed requirements for trustees to:

- select at least one appropriate 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;
- obtain data relating to the metrics as far as trustees are able; and
- calculate and disclose the emissions-based metric(s) and the non-emissions based metric(s).

It is proposed that statutory guidance would set out the following matters to which trustees must have regard:

- the levels at which metrics should be calculated and reported - for example, the individual sections of a scheme with DC and DB sections, or the individual fund- level;
- a list of the metrics from which at least one emission-based metric and at least one non-emissions-based metric should be selected to measure and manage climate-related risks and opportunities - including the expectation that the Weighted Average Carbon Intensity (WACI) should be used for the emissions- based metric;
- in relation to emissions-based metrics, calculating GHG emissions in line with the GHG Protocol methodology to allow for aggregation and comparability across asset classes and funds and between schemes;
- incorporating performance metrics into remuneration policies, where this is done;
- the historical periods used in calculation of metrics to allow for trend analysis;
- setting out reasons for any difficulties in acquiring adequate data;
- describing the methodologies used to calculate or estimate metrics; and
- how the metrics are used in investment decision-making

Do you agree with these proposals?

◆ We agree that one GHG-based metric should be disclosed. This is in line with the recommendations of the TCFD. However, a total scheme metric cannot be disclosed due to the lack of availability of data for a number of asset classes and funds.

- Currently there is limited market-wide data on the underlying transition readiness of portfolio companies and thus the alignment with the goals of the Paris Agreement, but we expect this to continue to improve over time. We agree with the proposal that metrics should be kept under review, however we disagree that they should mechanistically lead to targets. The data quality does not yet exist for trustees to be making annual strategic changes to the portfolios.
- Pension schemes are reliant on a combination of underlying portfolio companies, asset managers and third-party data providers to be able to disclose the emissions-related metrics for the scheme. As such, data collection can take a number of months and even then potentially yield only limited coverage and a mixture of results. Further, portfolio companies do not disclose data on a quarterly basis, rather they do so annually. Thus, we would question whether quarterly monitoring or disclosure is practicable and in any event we take the view that quarterly monitoring would only encourage short-termism.
- For pension schemes' TCFD statement, the emissions disclosure is in the context of a Pension Scheme Trust. The majority of emissions are classified as scope 3, category 15 (investments) which are calculated as the combined proportional scope 1 and scope 2 emissions of underlying investments. This is in line with the recommendations of the GHG Protocol[1]. For a pension scheme, scope 1 & 2 emissions directly relating to its business operations (e.g. use of office space), are likely to be immaterial. Furthermore, the calculation of combined scope 3 emissions of portfolio companies would contain material double counting across industry value chains. We suggest the guidance makes clear what carbon accounting practices trustees are expected to adopt.
- As mentioned previously, the sharing of good practice is vital for the measurement of GHG emissions to lead to better investment decisions. The combination of metrics to provide an indication of the forward-looking transition potential of the investment is far more valuable than backward looking emissions metrics. The risk of unintended consequences is material and should be recognised by the DWP as part of the policy proposal.

[1] https://ghgprotocol.org/sites/default/files/standards_supporting/Chapter15.pdf

Q9. The DWP 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 target(s).
b) calculate performance against those targets as far as trustees are able to disclose that performance.

The DWP propose statutory guidance will cover the matters outlined in the box below.

Box 12: Statutory Guidance on Targets

With regard to the proposed requirements for trustees to set and disclose the targets used by the scheme to manage climate-related risks and to measure, as far as they are able, their performance against those targets, it is proposed that statutory guidance sets out the following matters to which trustees must have regard:

- whether the target is absolute or intensity based;
- time frames over which the target applies;
- base year from which progress is measured;
- key performance indicators used to assess progress against targets; and
- the expectation that, where not apparent, trustees will provide a description of the methodologies used to calculate targets and measure performance against them, including any estimations used to measure performance.

Statutory guidance would also set out that trustees should describe, in their TCFD Report, how they have approached each of the matters above.

Where they choose to deviate from the approach set out in the guidance, trustees would be expected to describe the reasons for divergence in the relevant section of their TCFD Report

Do you agree with these proposals?

- Targets have a role to play in a robust climate-mitigation / impact strategy. However, they need to be well thought out as well as accompanied by relevant metrics and integrated into a decision-making framework to avoid a check-box approach to compliance. Requiring annual targets to reduce emissions intensity could potentially trigger significant unintended consequences, including investment decisions that erode member value, a reduction in appetite for positive engagement with companies and the potential for trustees' fiduciary duties to become compromised should investment choice be juxtaposed with members' financial outcomes.

Q10. The DWP 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?

- We are supportive of these policy proposals but would point out that given the number of other required scheme disclosure obligations there is likely to be material overlap, notably if a trustee's climate risk policy is disclosed in the SIP. It would be helpful if due regard could be given to this, particularly since the intended audience is the scheme membership.

Q11. The DWP 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, the DWP propose to model the compliance measures on the existing penalty regime set out in regulations 26-33 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?

- We have no comment on the proposed role of tPR. We do note however tPR's power to administer penalties for inadequate disclosures and would suggest it may be helpful for industry if there is guidance available as to how such inadequacy is proposed to be assessed.

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 the context of our experience, we think that the likely cost impacts for schemes have been materially underestimated. The disclosures are complex reports that have to be produced through a combination of outsourced data providers, investment managers, multiple advisers, significant internal resource and hours of trustee governance time. Furthermore, given that the TCFD statement is a required inclusion in the Annual Report and Accounts, the contents must undergo an independent assurance process, the cost of which is not inconsiderable and does not appear to have been reflected in the impact assessment.

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 the DWP's proposals?

- No further comments.