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

Consultation Response

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Hymans Robertson LLP

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Introduction

Hymans Robertson provide independent pensions, investments, benefits & risk consulting services, as well as data & tech solutions, to employers, trustees and financial services institutions.

We welcome the proposal to introduce further governance and reporting requirements on climate risk by occupational pension schemes. Occupational pension schemes are generally not managing climate-related risks as rigorously or effectively as they should be and so the imposition of an internationally recognised framework is both timely and helpful. The TCFD framework itself is a good one – a top-down approach gives easier access for newcomers, a blend of qualitative and quantitative techniques makes it easier to integrate with existing risk management approaches and the flexibility described in the consultation should allow schemes to take an approach that is suited to their circumstances.

We comment on the specific questions raised in the consultation document later in our response but our key points are:

- The requirements should nurture the right behaviours rather than being interpreted as just another compliance exercise. It's what pension schemes do that matters, not what they say they do.
- Management of short-term vs long-term risk is important – methods shouldn't pollute this balance or lead to inappropriate action.
- The Regulatory/legislative environment should be supportive – schemes having sufficient time to consider and implement the requirements with feedback and support available to those deemed to have fallen short of requirements. Disclosure of information should be targeted at those stakeholders most likely to enact significant progress on climate risk.

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What category best describes you or your organisation?
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1 Background and summary of proposals

There are no questions within this section to respond to.

We note chapter 1 details wider activity ongoing as part of the green finance initiative. We welcome a joined-up approach to this issue, taking into account all stakeholders (companies, pension schemes and asset managers). For example, uniform reporting from asset managers on climate risk will be essential for trustees to have the data available to prepare comprehensive TCFD disclosures. To deliver this asset managers need the companies they invest in to produce climate reporting information. A co-ordinated approach is therefore essential to ensuring policy success.

2 Scope and timing

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?

We agree that the proposed schemes should be in scope.

It may also be sensible to include (either initially or as part of future consultations on extending the requirements) commercial consolidators. These organisations may fall below the £1bn asset threshold at the outset but are likely to adopt best practice from a governance and risk management perspective.

We would suggest that further clarity on where the responsibility sits for authorised master trusts where there are shared governance arrangements. For example, are the requirements the sole responsibility of the Trustee of the master trust or would the IGC of the schemes also be held responsible?

For schemes who have less than £1bn of assets, voluntary adoption could be encouraged.

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 if earlier.

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 these policy proposals?

The phased approach seems sensible but the wording can be difficult to interpret for every scenario so the examples are very useful.

The 31 December 2022 and 31 December 2023 cut off dates seem unnecessary and may create unintended consequences whereby schemes have only a short period to produce TCFD disclosures, well ahead of the deadline for finalising the trustee report and accounts. For example, an £8bn scheme with a scheme year of 1 October to 30 September would fall in scope from 1 October 2021 and must publish their TCFD report within 7 months of 30 September 2022 or 31 December 2022 if earlier. This leaves only 3 months and would mean preparing and publishing the TCFD report up to 4 months ahead of the trustee report and accounts. We would therefore suggest the deadline of 7 months after the end of the relevant scheme year (without a backstop date) is the best approach and aligns with the trustee report and accounts deadline.

We agree that having a lower threshold for falling outside of the requirements is sensible to avoid schemes switching in and out of scope due to asset volatility. However, we would question whether the £500m lower threshold is reasonable with respect to the £1bn threshold as this creates disparity with schemes in the £500m-1bn range. For example, a scheme whose asset size falls from £1bn to £550m remains in scope whereas a scheme with assets of £950m is out of scope. Shifting the £500m lower bound to say £750m may be more sensible.

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 are supportive of considering whether to extend the requirements to schemes under £1bn. However, thought would need to be given to ensure the requirements could be met on a cost effective and efficient way for smaller schemes as full TCFD compliance may be disproportionately costly and onerous. A potential solution may be to consider a 'light touch' approach in the guidance which could be applied by smaller schemes.

A review taking place in 2024 will likely mean any changes won't materialise until 2025 or later. Given the timeframe of transition risks could be as short as 5 years or less this could lead to smaller schemes being relatively more exposed to risk (vs the larger schemes who will be evolving their approach from 2021 onwards) in the interim. However, we appreciate that this approach gives scope for understanding how the process has worked with the larger schemes and being able to implement those learnings more efficiently for smaller schemes.

To combat the above, we believe the guidance should be clear that whilst the reporting requirements do not apply to smaller schemes they are strongly encouraged to following the TCFD principles to ensure they are effectively managing climate risk. The guidance that is released for the schemes falling under scope could be denoted as the best practice for smaller schemes.

3 Climate governance and TCFD

Governance Proposals

Q4. We propose that regulations require trustees to:

a) establish 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 process by which trustees satisfy themselves that this is being done.

We propose that statutory guidance will cover the matters in the box above. (see p.55 of the consultation)

Do you agree with these proposals?

We agree with the overall proposals. To assist trustees in meeting the above requirements, the guidance could include an example climate policy outlining the various roles/responsibilities to illustrate how trustees can document the above.

From a governance perspective, the statutory guidance should highlight the importance of trustee knowledge and understanding in this area. With that in mind we would suggest that the Pensions Regulator extent the trustee toolkit to include climate change/risk as a module and require that trustees have the knowledge and understanding to complete the requirements.

Strategy Proposals

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 (see p.58 of the consultation). Do you agree with these proposals?

We generally support these proposals, but note the following observations:

- We would question whether reference to short-term risks and opportunities could promote short-termism from asset owners. Whilst short-term risks may exist and these may need to be managed, this needs to be balanced against the need to ensure longer term sustainability, having regard to key risks and opportunities.

- Given the broad nature of the proposals, and flexibility in how this can be applied in practice, it is difficult to envisage a scenario where an asset owner would determine that they have deviated from the approach set out in guidance, and require to comment on this. We have assumed that this section is included as ‘belt and braces’. If there are specific scenarios envisaged, it would be helpful to articulate these in the guidance to make asset owners aware of what is likely to fall foul of the requirements;

- We note references to application in DB schemes and impact on investment and funding strategies. With regard to DC schemes, we think it would be useful to reference impact on investment strategy and member outcomes. The latter should cover both financial-driven aspects and non-financial. For example, the impact of changing levels of member engagement. There is a specific risk related to this scenario around disengagement from members due to lack of proactivity from asset owners in addressing climate related risks and opportunities.

Scenario Analysis

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 (see p.63 of the consultation). Do you agree with these proposals?

We have a number of comments on this section, set out below. Overall, we believe the guidance will be useful for asset owners to develop an understanding of how to develop an approach to scenario analysis. However, we are concerned that the proposals could lead to ‘group think’ and/or a lack of analysis and understanding of the key climate-related risks and opportunities.

- The proposals provide for at least two scenarios to be considered. We feel this scope is too narrow, and would prefer at least 3 scenarios to provide improved breadth of understanding of potential climate-related impacts;

- Allied to the above, we believe that asset owners should be asked to articulate why they have chosen the scenarios they have to avoid the selection of potentially more favourable scenario outcomes;

- Reference to “2°C or lower scenario” in our view will lead to a degree of ‘group think’, with most asset owners taking this as guidance to use a 2°C scenario. It may be preferable to describe the scenarios in the form of the transition that is expected to occur, i.e. orderly or disorderly.

- For DC schemes, the potential impacts on member outcomes, both financial and in terms of engagement, should be considered. To reflect the different time horizons of members, it would be beneficial to consider impacts for younger and older members;
- It is unclear whether the proposals bring self-select assets for DC schemes within scope. Our preference would be to maintain focus on default arrangements, given investment choice is solely directed by the asset owners. However, it may be beneficial to provide separate guidance to make climate-related information available to members investing in self-select funds, alongside other financial information.
- For DB schemes, we believe it will be important to undertake climate scenario analysis on employer covenant. This would be more consistent with the current regime of integrated funding, investment and covenant considerations. This would be supported by schemes in scope having sponsors produce reporting in line with TCFD recommendations;
- In general, we feel practical examples or case studies will be helpful, to bring this area of guidance to life.

Risk Management

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 (see p.65 of the consultation) above.

Do you agree with these proposals?

In general, we feel guidance in this area will be useful. We have some specific observations:

- There appears to be a significant degree of overlap in proposals in this section with Q4;
- We feel there is an opportunity to clarify that Q4 relates to setting policies, whereas this section relates to the actions being taken as part of a strong risk management process;
- Our general view is that the underlying governance and actions being taken by asset owners creates genuine value, whereas reporting is more of a by-product of this process. To address this, we suggest emphasis should be placed on outcomes-based reporting rather than policy-based. This approach will more clearly establish the value added from asset owners' policies, and areas where value can be added in future.

Metrics and Targets Proposals

Metrics

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 that regulations require trustees 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 required 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 (see p.72 of the consultation) above.

Do you agree with these proposals?

As a general view, we do not believe that progress against plans to address climate-related risks and opportunities can be explained by a single metric. Multiple metrics are required to provide a broader indication of progress.

- We are concerned that the guidance will lead to 'group think' and many asset owners adopting metrics that are merely referenced in guidance (e.g. WACI), rather than considering the validity of different metrics in different circumstances. Our preference would be for the guidance to encourage asset owners to develop a core understanding of the different types of metrics available, and their uses and limitations and select metrics that are appropriate to their scheme.

- For example, guidance should give examples of metrics that could be used (e.g. weighted average of carbon intensity) and give benefits and disadvantages of each approach so trustees are able to make more informed decisions on what is best suited to their circumstances or whether there is another, more innovative approach to take.

- In promoting improved reporting practices from asset managers, we suggest that asset owners are encouraged to report where asset managers are unable to provide the data requested e.g. if Scope 3 emissions data is not provided, along with plans to improve practices in future. This approach is consistent with the approach applicable to DC trustees in addressing missing information in Chair's Statements.

- We also note that (assuming various policies are successful) availability of data on climate risks is likely to improve over time. It may be worth clarifying that gaps may exist in the early years of disclosure but the metrics can be developed over time as further data becomes available.

Targets

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 the target(s).

b) calculate performance against the target(s) as far as trustees are able and disclose that performance.

We propose statutory guidance will cover the matters outlined in the box (see p.76 of the consultation) above.

Do you agree with these proposals?

Whilst ongoing monitoring against agreed targets can be helpful in terms of focussing attention and resource, care must be taken to ensure that the focus on target does not obscure the strategic objective or, worse, undermine it by causing more short-term tactical behaviours that may conflict with it.

Under a) we would make the following observations:

- Use of one target is unlikely to be a good means of managing an expansive risk and could tend to concentrate attention on a small number of metrics. Such issues have arisen in the financial sector before (for example an over-reliance on "VaR" measures) with undesirable consequences. Pension schemes are well used to using multiple risk-management metrics e.g. the IRM funding framework. Industry-wide focus on a small number of measures could also lead to these measures becoming less reliable if asset originators and/or managers were able to find ways to make scores more appealing. We would prefer a suite of targets to be required (at least three and, in most cases, five or six).

- Annual resetting of targets will encourage short-term thinking – both in terms of the target selection and the risk management of the scheme. We would prefer targets to be reconsidered triennially, in conjunction with a scheme's triennial review of funding and investment strategy in order to better facilitate long-term thinking and integration with existing risk management functions. Triennial reviews would be more likely to generate better behaviours, with careful thought and rigour being applied rather than being seen as an annual compliance exercise.

- Targets are helpful but it is actions that matter and this needs to be stressed. For example, management of a specific target may be most efficiently enacted through disinvestment. However, activist engagement may yield better results for the scheme in the long-term (not to mention the wider societal externalities). There needs to be a clearly articulated vision for how targets will be managed, why this is the chosen method and the timescales over which each target should be considered. Targets shouldn't become an end in themselves.

On b):

- Monitoring of performance is helpful but care should be taken that it doesn't encourage short-term tactical behaviours that may be at odds with longer term strategic objectives.

- Quarterly monitoring, we believe, is too frequent. Practically, much of the data used in the monitoring assessment (e.g. carbon emissions) will be updated less frequently so quarterly monitoring is likely to yield little additional added value relative to, say, annual monitoring. In some instances it may lead to behaviours opposed to those desired. Pension schemes are (in most cases) long-term investors and their focus should remain on their ultimate objective of paying benefits as they fall due. Frequent monitoring of a limited number of metrics will distract from the overall objective by creating a metrics-based micro-managing mentality.

4 Disclosing TCFD

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 most recent 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 most recent published TCFD report to the Regulator by including the corresponding web site 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 web site 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 requirements set out in a) to e). Some general comments:

- For scheme accounts purposes, we would prefer links to the various governance reports (TCFD, SIP, Chair Statement) to be provided rather than inclusion of the full documents to avoid cluttering and potentially distorting the accounts. Accounts are intended to be a factual description of a current financial position rather than an overt risk management publication.

- Transparency lies at the heart of a functioning financial system and so we agree strongly that the report should be made available publicly. To the extent that attention is drawn to the TCFD report, care should be taken to ensure that attention is encouraged from the appropriate sources. For example, we do not think that scheme members should necessarily be strongly led to the report. Much of the content of the TCFD report will be of a very technical nature and written from the perspective of, and for the explicit use of, pensions professionals. In our view, very few members will be interested in, or capable of fully comprehending, the report. The most important audience for the report includes the Pensions Regulator, pensions advisers and other pension schemes. It is in these areas that engagement should be encouraged.

5 Penalties and Impacts

Penalties

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?

Firstly, the proposals under a) and c) appear contradictory and so more detail here would be helpful. Generally, we have the following comments:

- We view the reporting as secondary in terms of value to the underlying governance and risk management procedures. This is because, for pension schemes, there are no external investors making financial decisions based on information in published financial statements. We therefore would prefer regulatory scrutiny to focus more on the underlying processes than the reporting (and assuming one is a proxy for the other could be misleading).
- Setting out a framework of financial penalties for non-compliance in this area will be challenging. Firstly, the TCFD requirements are deliberately non-prescriptive in many areas, requiring trustees to assess the most appropriate approach for their scheme. Secondly, what's appropriate will be scheme-specific and depend on a number of variables (funding position, asset strategy, strength of sponsor, future lifetime of scheme etc). Trying to set out a consistent approach to penalising non-compliance that is seen as "fair" will be difficult.
- Imposition of fines creates an inherently hostile dynamic. We would much rather see the Pensions Regulator working with schemes to evolve and develop best practice in this area. Fines also encourage a mentality of "ticking the box" where trustees work in such a way that they avoid punishment rather than manage a particular risk. A spirit of cooperation would better enable the desired behaviours than a system of punishments for non-compliance.
- Great care needs to be given to the imposition of penalties before including in guidance or legislation as it could undermine industry objectives. For example, the "Chairs Statement" was a sound idea but, in practice, has very limited value as it is generally viewed as a compliance item. We need to avoid further such instances of this approach.
- We agree that non-compliance ought to attract a fine but would rather all other infringements are resolved via engagement. We would also encourage an early review of reporting and recommendations be made on areas of best practice or weaker disclosure that have emerged, in line with the approach undertaken by the FRC for the UK Stewardship Code.

- We would suggest that, in the early stages of TCFD reporting, fines are not generally applied and that engagement is used instead. Over time, once the framework becomes more established and more universally adopted, the penalty framework is reconsidered, preferably through formal consultation.

Impacts

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?

The requirements of the TCFD reporting framework are onerous. Schemes will generally be starting from a very low level of existing compliance and, moreover, trustees and their advisers may not be familiar with TCFD or the management of climate risk explicitly. Successful implementation will require careful thought and bespoke technical analyses meaning that the time, effort and cost of compliance should not be underestimated.

Implemented well, the requirements shouldn't be prohibitive and should focus trustees' minds on prioritisation of actions to mitigate climate risk, rather than becoming just another regulatory burden. Given their importance to scheme members and the wider economy, it is highly desirable that processes and reporting are aligned with the internationally recognised TCFD framework.

Protected groups and other comments

Q13: Do you have:

a) any comments on the impact of our proposals on protected groups and/or 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?

Trustees have a fiduciary duty to protect the interests of their scheme members. Climate risk will be discriminatory in its implications (for example by income or geographical location). Whilst trustees may consider the make-up of their particular scheme, it must be in the context of using their powers to best ensure that they meet the objective paying benefits as they fall due (DB) or maximising value for members (DC).