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By email: pensions.governance@dwp.gov.uk

Date: 6 October 2020
Your ref: Climate change consultation
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Dear Sirs

Response to consultation on taking action on climate risk: improving governance and reporting by occupational pension schemes

This letter sets out Eversheds Sutherland's comments on the above consultation which was issued on 26 August 2020.

Introduction

We have one of the largest teams of pensions lawyers in the UK, with over 65 specialist pension lawyers. Our clients include employers, trustees of a number of the UK's largest public and private sector occupational pension schemes and some of the country's leading master trusts, insurance companies and pension providers.

Our response represents our own views on the consultation and not those of our individual clients (unless expressly stated otherwise). However, in forming our views we have taken account of our clients' interests and concerns as well as considering the potential impact of any changes on individuals, society and the wider pensions industry.

Comments on questions raised in consultation paper

Qu1: Schemes in scope of the new reporting requirements

We are supportive of the £1bn net asset threshold. In our view it represents a proportionate application of fairly onerous additional governance costs.

We do however have concerns about the proposed application to all master trusts and CDC schemes. If the additional governance costs could be 30% of total governance spend, this could potentially prevent new master trusts from entering the market. We are not clear that this would achieve the proposed level playing field in these cases.

In addition, we would observe that a small number of occupational pension schemes have unintentionally triggered master trust requirements because they hold DC benefits in relation to non-associated employers. We cannot see any reason why such "accidental master trusts" should be subject to the TCFD requirements where they have assets below the £1bn threshold.

Likewise, although CDC schemes will have to meet a similar governance framework to master trusts, they are initially proposed to be restricted to schemes for associated employers and hence, will be non-commercial in nature. The application of the new requirements to CDC schemes should be considered carefully, although we acknowledge that as members share the investment risk but have no control over investments, such schemes present unique issues.

There are several other scenarios where we consider that some or all of the new requirements should not apply, notwithstanding the asset value of the scheme:

- Segregated schemes where no single section exceeds the thresholds. In such schemes, each section will be operated as a separate schemes for most purposes, including investments. Separate investment strategies will have been set for each section, taking into account the views of different participating employers and the characteristics and demographics of the membership. We would suggest that where sections are treated as separate schemes for all other purposes, it would be sensible for this to also be the case when applying the new TCFD thresholds.
- Schemes with liabilities which are predominantly secured with an insurer via bulk annuity contracts, or which are expected to buy-out in the short term. We would suggest that such schemes should fall outside the scope of some of the proposed new requirements (e.g. concerning scenario analysis, metrics and targets) where the value of assets not held with an insurer falls below £500million. This is to reflect the fact that the costs of compliance are likely to be disproportionate to the benefits for scheme beneficiaries.

Qu 2: Do you agree with the policy proposals behind the proposed timing of the new requirements?

Broadly yes, however we have some concerns about whether all schemes in the scope of the first tranche will be able to comply with the new requirements by as early as June 2022.

In particular, the amount of work that a small master trust would need to do to comply with requirements in a fairly short period, could result in significant costs for relatively limited returns for members. We would also observe that if insufficient time for compliance is allowed, initial reports and disclosures may well contain little of value and thus undermine the new regime.

We also have some concerns about the requirements where asset value drops below £500m. We agree that the climate governance requirements should immediately cease to apply. However, we do not think that the scheme should remain under an obligation to publish a TCFD report for the previous scheme year. It may well be the case that little or no work has been undertaken on the report at the date the assets fall below the threshold and we are not clear that any benefits of a TCFD report to members would outweigh the disproportionate governance costs associated with producing the report.

Qu. 3: Do you support a review of the application of the TCFD requirements to smaller schemes in 2024?

Yes. We would urge the Government to consider how far the TCFD reporting requirements have actually proved an asset to scheme members, looking at how far they have affected member behaviours (for example, changes to self-selected DC investments) and whether they are read by more than a small minority of members. The usefulness of the information should form a key part of any assessment on whether to extend the requirements to smaller schemes.

Consideration should also be given to the extent to which the requirements have had any impact on overall trustee investment strategy and scheme investment returns.

Finally, whatever the outcome of the review, in our view there should be a minimum threshold below which the regime would not apply. This is to reflect the fact that for smaller schemes, the governance costs would be disproportionately high. The figures in paragraph 7 of Chapter 2 suggest this threshold might sensibly be set around £100m.

Qu 4: Regulatory requirements in relation to climate change risks and opportunities

We note that the Government's preference is for schemes subject to the TCFD reporting requirements to also continue to prepare and publish an implementation statement. Industry experience suggests that the more information that is made available to members in different formats, the less they engage with it. We have genuine concerns that TCFD reports will be read by very few members and would encourage the Government to consider the information that members receive as a whole and ensure that it is as straightforward as possible and there is no duplication between different statutory requirements.

In relation to the proposed statutory guidance which will require trustees to have regard to the persons managing climate change risk on their behalf, we would observe that the proposal as drafted refers to employees of the principal and controlling employers and external advisers. The adviser requirement appears to be satisfied if the trustees are satisfied that the relevant firm is appropriate. We think that this is correct. However, where services are provided by an employer, the trustees appear to be required to consider the suitability of individual employees. We consider that this is impractical and it would be better to require them to consider whether the corporate entity as a whole has the appropriate knowledge and experience.

Qu 5: Disclosing climate change risks and opportunities over the short, medium and long term, and assessing impact on investment and funding strategy

The consultation paper conflates investment and funding strategy, requiring trustees to consider the impact of climate change risks and opportunities "*on the scheme's investment strategy and, where relevant, their funding strategy*".

In our view, the trustees should not be required to make specific climate change assessments and disclosures in relation to their funding strategy. This would suggest that trustees may need to do assessments in relation to the climate change exposure of sponsors and could even require an additional formal covenant review. This would go beyond the stated aims of the TCFD requirements which focus on the role of institutional investors in managing climate change and create additional compliance requirements and governance costs for DB scheme trustees. It could also constrain funding negotiations and limit the disclosure of confidential information relating to the covenant of the scheme by the sponsor if trustees were obliged to disclose such information publicly.

In so far as funding and investment strategy are linked, any climate change impact on the investment strategy will automatically feed through to funding without any need for any express requirements to be set out on the role of climate change in scheme funding. Understanding the potential impact of climate change on employer covenant is something which would be addressed in any event during the valuation process.

It is also worth noting that some sponsors will always be perceived as a greater risk in terms of climate change factors due to the nature of their business/industry. However, such risks will be addressed through the schedule of contributions and any recovery plan. If sponsor related climate change risk needs to be further flagged, this may lead to members considering transfers-out (which may not be in their best interests).

As a separate point, we would welcome further guidance on whether trustees would be able to rely on (or simply cross-refer to) the TCFD report of issuers of pooled funds or providers of bulk annuity policies, rather than replicating such analysis.

Qu 6: Do you agree with the proposals on scenario testing?

Trustees have to take into account many factors in relation to investments when determining whether they are appropriate for their scheme. Their principal duty is to ensure that the scheme assets are invested in the best interests of the membership as a whole, having regard to the risks associated with a particular investment.

We acknowledge that it is appropriate in this context for trustees to have a risk and governance framework around climate change related issues. This is consistent with their trust law duties. However, the detailed scenario testing requirements effectively elevates climate change concerns above all other investment issues as a result of the amount of time and scheme resources that will need to be allocated to it. We do not consider that this is appropriate or in the interests of members.

Qu 7: Do you agree with the proposal that regulations and guidance should set out a requirement for climate change processes?

We are unclear what the proposals in the consultation paper would add to the existing actions which a well-governed, strong trustee board should be taking in the context of existing risk registers. As a result, we would urge against the adoption of detailed requirements which could result in box-ticking compliance, increased costs and little positive outcome for members.

In general, in relation to questions 5, 6 and 7, whilst we accept that climate change is an important issue, we would question whether it is appropriate that a disproportionate amount of money (which in a DC scheme may come from members) may ultimately be spent in reviewing a single aspect of an investment and the potential risks and rewards associated with it. This may not benefit the membership as a whole.

Qus 8 and 9: Do you agree with the proposals on selection of metrics and targets?

For the reasons set out in relation to question 6 we consider that these proposals are too prescriptive in a trust context where trustees are required to balance multiple factors and ensure that they act in the best financial interests of the scheme members overall. In addition, we would question whether the information produced as a result of these specific requirements is likely to be meaningful to the majority of members.

Any assessment of the metrics used by schemes should take into account the data available for scheme assets. In certain cases this may be limited (e.g. illiquid assets, private assets, bulk annuities) and penalties should not be applied rigidly to schemes where this is the case.

Where schemes do set targets, these would need to reflect trustees' wider fiduciary duties and be in line with the purpose of the scheme – e.g. to improve member outcomes and enhance the security of benefits. They would also need to be reflect the wider investment and funding strategy of the scheme and the maturity and profile of its membership. In some cases, metrics and targets may be of limited benefit to schemes with a clear end game and which have specific, short term investment goals (e.g. achieving buy-out) or where they are constrained in the targets that can be achieved (e.g. where a substantial proportion of assets are invested in bulk annuities).

We would also note that there is a risk that if trustees have not met a target through no shortcoming in their stewardship or other duties, members might still feel they have grounds for complaint. It such cases, the Pensions Ombudsman, court or Regulator could be in the position of trying to reconcile a failure to meet a climate change target with the fact that the trustees had acted entirely consistently with their fiduciary duties and in members' interests.

We would therefore welcome adjustments to the regime which would allow these recommendations to be applied flexibly, in a way that best reflects the interests of the beneficiaries of each scheme.

Qu 10: Do you agree with the proposals on publishing TCFD information and providing it to the Pensions Regulator?

Generally yes. However, we would observe that there is an increasing amount of information included on an annual statement sent to members. Having been involved in the simpler annual statement project, we are aware that the statement needs to be kept short to facilitate member engagement. Therefore, we would be reluctant to see additional information signposting added to it and would prefer to see an approach where members were simply signposted to more information about investments and charges rather than to a list of specific information.

We are not in favour of signposting DB members to the TCFD report via the summary funding statement. As we said in our response to question 6 above, the funding and investment regimes should not be conflated and flagging climate change issues in a funding document could cause members to have unnecessary concerns about scheme funding.

Qu 11: Do you agree with the proposed approach to penalties?

No. We would be opposed to any mandatory penalty regime. In the view of the industry the existing mandatory penalties in relation to chair's statements have not been successful and have often resulted in disproportionate fines. We note that mandatory penalties are only proposed where there has been a complete failure to produce a TCFD report (and welcome assurances that they would not apply in other cases) but still consider that the Pensions Regulator should be able to consider the reasons why no report has been issued before imposing a penalty. We do not consider that delays in publishing the report should trigger a mandatory fine, without the Pensions Regulator taking into account reasons for that delay.

Where the Pensions Regulator is able to impose discretionary penalties for inadequate TCFD reports, this should be underpinned by clear guidance as to what the Regulator will consider to be inadequate. Such guidance should not be unduly prescriptive and should be principles based.

We would also encourage the Pensions Regulator to engage with schemes directly and make its expectations for improvement clear (e.g. though its 1-2-1 process) before imposing fines –

particularly for the first rounds of schemes which will be required to comply with the new regime.

Qu 12: Do you have any comments on the new regulatory burdens to business and benefits, and wider non-monetised impacts we have estimated and discussed in the draft impact assessment?

We anticipate that the costs of complying with the TCFD recommendations, particularly for schemes with a complex investment profile or which do not already have processes in place to comply on a voluntary basis, will be significantly higher than the £15k estimated by the Government.

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If you have any queries in relation to any of the points raised in this letter, please contact Karen Mumgaard at karenmumgaard@eversheds-sutherland.com.

Yours faithfully

Eversheds Sutherland (International) LLP