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

Aon's response to the DWP's consultation

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Introduction

Aon is pleased to submit its response to the DWP's consultation entitled "Taking action on climate risk: improving governance and reporting by occupational pension schemes".

Aon is a leading global professional services firm providing a broad range of risk, retirement and health solutions, with more than 50,000 colleagues in 120 countries. We work with the trustees and sponsors of around 1,000 UK pension schemes. Globally, we work with more than 2,300 clients with assets totaling $3.8 trillion.

Executive Summary

The discussion surrounding the financial impact of climate change has gained significant momentum in recent years. The policy proposals that are set out in this important and timely consultation – along with the forthcoming detailed statutory guidance – are likely to be significant drivers of positive change across the pensions landscape. We unreservedly welcome that.

Aon supports the principles set out in this consultation and the spirit of the proposals, all of which are sound. The policy proposals strike a good balance between the inevitable increase in governance burden on trustee boards and the need for this important and ever-increasing risk to be considered as fully as possible and without delay. With that said, some nuances around the scope and timing of the proposals could be addressed or clarified and we point these out in our response.

The forthcoming statutory guidance will be critical to the ultimate successful adoption and use of these proposals. Equally important is TPR's continued leadership and active engagement on the topic of climate change risk, especially as trustee boards educate themselves about the new requirements and work to put effective governance and reporting frameworks in place. Many trustee boards have already done a significant amount of work to this end and the proposals set out in this consultation will provide comfort that they are on the right track. Detailed statutory guidance can only provide further confidence to this end.

We look forward to the outcome of this consultation and to further engagement with DWP, TPR and other stakeholders on this critically important issue.

Response to Consultation Questions

Question 1

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

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

b) authorised master trusts

c) authorised schemes offering collective money purchase benefits

Do you agree with our policy proposals?

Aon response

We support this proposal. It would capture nearly three-quarters of the UK occupational pension scheme market by assets by the end of 2023 and strikes a good balance between the need for trustees to incorporate climate change risks into their governance arrangements and the need to be mindful of smaller schemes' governance capability and resources. We note that fewer than 40 stand-alone DC schemes would be covered by the new regulations by the end of 23, meaning that the vast majority of stand-alone DC schemes are not captured by virtue of their size.

We would, however, welcome clarity on how the 'edge' cases would be treated, including schemes with significant buy-ins, where there is no expectation of surrender and where there is limited-to-no opportunity to direct the way the assets are invested. Excluding buy-in policies from the asset threshold calculation could be a pragmatic approach thereto.

With many pension schemes targeting buy-out as a long-term goal, trustees will want to know how insurers are incorporating climate change risks and opportunities into their governance and investment processes. We note that the FCA and PRA have coordinated to provide practical recommendations on climate-related risk management to firms within the scope of their respective regulatory responsibilities but would welcome pension scheme-specific guidance, aimed at trustees, by TPR.

Question 2

We propose that:

a) trustees of schemes with £5 billion or more in net assets on their first scheme year end date to fall on or after 1 June 2020 are subject to the climate governance requirements from 1 October 2021 and the trustees must publish a TCFD report within 7 months of the current scheme year end date or by 31 December 2022 if earlier *b) trustees of schemes with £1 billion or more in net assets on the first scheme year end date to fall on or after 1 June 2021 are subject to the climate governance requirements from 1 October 2022, and the trustees must publish a TCFD report within 7 months of the current scheme year end date, or by 31 December 2023 if earlier*

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

After 1 October 2021:

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

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

From 1 June 2022 onward:

f) trustees of schemes not already in scope of the requirements and with £1 billion or more in net assets on any subsequent scheme year end date:

- *are subject to the climate governance requirements starting from one year after the scheme year end date on which the £1 billion asset threshold was met*
- *must publish a TCFD report within 7 months of the end of the scheme year from which the climate governance requirements apply*

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

Do you agree with the policy proposals?

Aon response

We agree with the phased approach but would welcome more flexibility on timing for schemes with year ends towards the end of the year, such as schemes with 30 September year-ends. Based on our understanding of the proposals, such schemes would effectively have three months from their year-end dates to prepare and publish their TCFD reports:

- 30 September year-end schemes with £5 billion or more in net assets on 30 September 2020 would need to prepare and publish a TCFD report covering 1 October 2021 – 30 September 2022 by 31 December 2022.
- 30 September year-end schemes with £1 billion or more in net assets on 30 September 2021 would need to prepare and publish a TCFD report covering 1 October 2022 – 30 September 2023 by 31 December 2023.

From experience, three months would not be enough time for trustees to prepare, review and sign off TCFD reports. If our understanding of the proposed timescales is correct, we would welcome an alternative timetable for schemes with 30 September year-ends (and other dates towards the end of the year) to give those schemes enough time to prepare their TCFD reports. For example, an approach that allows such schemes to publish their reports within 7 months of the scheme year-end date.

The asset threshold test, while appropriate in our view as a proxy for the level of governance resource available to trustees, may lead to confusion or ambiguity in practice. We would welcome a point of contact at TPR – or an online tool or portal – that trustees and their advisers could consult to confirm whether a scheme is within the scope of the new requirements and give some level of comfort before they proceed.

Question 3

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

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

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

Do you agree with these proposals?

Aon response

We agree with these proposals.

Question 4

We propose that regulations require trustees to:

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

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

We also propose that regulations require trustees to describe:

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

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

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

Do you agree with these proposals?

Aon response

We agree with these proposals and note that the intention is to adopt the language of the TCFD recommendations – which were prepared for use by any organisation – to UK pension schemes and to "provide a great deal of guidance which underpins the TCFD recommendations", including by providing options and examples for trustees on how to meet the new requirements. At the same time, we welcome the flexibility afforded to trustees by allowing them to take their own approach, which will help foster innovation, particularly in the early stages of adoption. However, while most – if not all – assets have some degree of exposure to climate risk, climate change risks and opportunities will vary by asset class, strategy and even manager style. Any definition of climate change risks and opportunities should reflect this inherent heterogeneity across assets.

We also agree with the ongoing / discrete split of activities, as well as the activities that have been categorised as such. However, we believe that making it a requirement for schemes to carry out scenario analysis annually could be less-than-useful and potentially costly, especially in the absence of material changes to the scheme's circumstances (e.g., its liability profile or investment strategy) or market conditions over the year. Instead, we suggest that trustees should conduct scenario analysis at least every three years – which ties in with actuarial valuation cycles and potentially asset-liability modelling exercises – or more frequently if there has been a material change in the scheme's circumstances or position. We would therefore favour a policy which requires that trustees, on an annual basis, consider whether they should run 'fresh' scenario analysis or whether the conclusions of the most recent scenario analysis are still valid and appropriate (and that trustees explain and disclose why they believe that to be the case if they decide the latter).

Additionally, while it is reasonable for trustees to monitor their climate change risk on as frequent basis as possible (through qualitative assessments which are complemented by emissions and non-emissions based data), we have some concern that quarterly reviews of emissions and non-emissions based data could be too frequent. While trustees do often meet at least quarterly, it is often the case that meeting agendas are packed, and trustees have an abundance of matters to review and decisions to make. We would instead suggest at least annual monitoring of emissions and non-emissions based data, complemented by more frequent non-data based assessments where appropriate.

Finally, clear lines of responsibility and delineation of roles and duties is a key part of the TCFD's 'governance' pillar. While ultimate responsibility for managing climate change risks and opportunities lies with trustees, we would like to see the statutory guidance recognise that trustee boards vary greatly in their degree of reliance on and interaction with advisers: some trustee boards rely entirely on internal pension teams and managers, whereas others delegate a great deal to external advisers (for example, through fiduciary management). Many trustee boards have long-standing relationships with their external advisers and would want them to be closely involved in helping the trustees assess and integrate climate change risks into their governance processes, so we would welcome some flexibility in the statutory guidance to allow trustees to establish and work within a governance framework that best meets their needs.

Question 5

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

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

Do you agree with these proposals?

Aon response

The principles proposed seem reasonable, although similarly to other questions, the statutory guidance will be important to provide the necessary detail for how this will be achieved. We would expect that the guidance would make specific reference to the PCRIG guidance, clearly pointing trustees and their advisers to the relevant sections.

We are not convinced that the reference to short/medium/long term is sufficiently well-defined to help schemes understand these time horizons. TPR has tried to be more specific in the recent consultation on the funding code by giving a measure of what "significantly mature" is in terms of scheme duration. There is a risk that some schemes, for example those closing in on buying out their benefits, may consider these risks less relevant as their short-term focus is on passing their liabilities to an insurer.

We expect that trustees (and companies) will have a major concern about disclosing sensitive non-public information which they are party to as part of employer covenant or wider discussions regarding climate change risks relevant to that scheme. For this reason, we think it would be worthwhile having a carve-out for censoring non-public information when reporting back the climate change risks and opportunities identified for that scheme.

Question 6

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

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

Do you agree with these proposals?

Aon response

We see climate change scenario modelling as an essential tool to help investors and pension scheme trustees to understand and communicate the impact of different climate change scenarios, including the effects of a transition to a low carbon economy. This in turn helps improve the quality of strategic conversations, which feeds into actions. We therefore welcome guidance which enables trustees to assess the resilience of their assets, liabilities, investment strategy and DB funding levels through scenario analysis.

The PCRIG guidance on TCFD recommends three alternative scenarios: an orderly transition to +2C or lower scenario, an abrupt transition +2C or lower scenario and a no transition pathway to a +4C scenario. We believe these three scenarios should be modelled as a minimum and assessed relative to a base case scenario, which incorporates the current median climate trajectory based on action and policies in place so far.

While we would expect to see guidelines supporting the requirement of scenarios, to ensure that they offer a sufficient stress test (especially in the case of the +4C scenario), we would recommend allowing a range of tools and metrics to be used to meet these requirements, as these are constantly evolving and improving.

Furthermore, this allows the best tools to be selected to address pension scheme idiosyncrasies. Ideally the recommended scenarios should combine qualitative and quantitative analysis. Fund-level scenario analysis can be difficult to do, particularly for the more complex strategies (for example, long/short hedge funds). Scenario analysis at the asset class level is our preferred approach. Trustees will be familiar with such analysis as it aligns with asset-liability modelling exercises which are now standard practice for many trustee boards.

The use of scenarios differs somewhat depending on whether they are applied to defined benefit or defined contribution pension schemes. For DB schemes the primary focus is to assess the impact of different scenarios on funding levels and sponsor covenants, as well as investment portfolios. The +4C climate scenario should serve as a stress test of the pension scheme.

For DC pension schemes, scenario analysis should focus on members' pension assets and the design of suitable default investment strategies. Defined contribution scheme trustees need to be able to consider what is appropriate to the membership demographics and the investment objectives of the investment options. Recommendations in the TCFD guidance and the PCRIG consultation should be used to clearly state the different requirements placed on these two types of pension schemes.

Scenario analysis should, at minimum, be run on the default fund. Whether scenario analysis is run on self-select funds should be at the trustees' discretion.

Question 7

We propose that regulations require trustees to:

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

We also propose the regulations require trustees to disclose:

c) the processes outlined in part a) above

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

Do you agree with these proposals?

Aon response

In our experience, this part of the TCFD is the most open-ended one and subject to interpretation. We look forward to the statutory guidance which covers the matters outlined and would especially welcome guidelines which sets out what a best practice approach could look like, including:

- How 'financial materiality' should be defined
- How often trustees should review their risk management processes

- Frameworks for identifying climate-related opportunities
- How trustees should document their activities so that they can evidence compliance with the new requirements

Question 8

We propose that regulations require trustees to:

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

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

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

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

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

Do you agree with these proposals?

Aon response

We believe our clients are looking for metrics which will enable them to understand, interpret and compare metrics, on a like-for-like basis, across portfolios to the extent possible. Their interest is in choosing the carbon emissions metric that gives them this ability and they will naturally look to their investment managers to provide this metric. To date, the flexibility offered by the TCFD has been welcome as an interim measure while market participants get up to speed with the increasing demands for transparency around carbon emissions. Latitude across reporting has been necessary to foster engagement and participation.

However, as familiarity of the TCFD framework grows and there is continued convergence of reporting regulations and regional guidelines, we would recommend that the ambition on carbon reporting should be towards specific, global and universally standardized carbon metrics. This would enable trustees to quantify and assess their climate-related investment decisions more effectively.

In the TCFD supplemental guidance for the financial sector, the reporting of weighted average carbon intensity as a first step was expected. This metric, in our view, should be standardized and built upon in terms of projected targets, with companies and investment managers offering this metric across all regions and sectors as the primary reporting metric. Other supplemental "advancements in the development of decision-useful, climate-related risk metric" should continue to be developed and will likely also be adopted by trustees, as appropriate to respective sectors.

In terms of a non-emissions based metric, these are important to maintain and add perspectives which allow trustees to avoid the pitfalls associated with a focus on a singular carbon emissions metric; both an emissions and a non-emissions metric are important and complementary. Trustees will again likely look to the market for the provision of the most relevant metrics.

Two suggested routes are a metric and a framework, for example:

- An *exposure to fossil fuel reserves* metric, in order to add perspective and identify exposure to stranded assets.
- A universally accepted framework such as that offered by the Transition Pathway Initiative, or equivalent. That is, an easily understood and accessible tool for trustees to use as a guide as to levels of climate management quality inherent to a portfolio.

Requiring trustees to report on why full coverage has not been achieved sets the expectation of comprehensive reporting – a bar which needs to be pitched with shortcomings articulated, justified and understood.

The calculation and disclosure of those metrics will become an easier task if global standardization is adopted. A further important consideration should be the ease of transferability across data providers with regards to the outputs of carbon reporting. Investment managers usually rely on a data provider to offer a platform for the calculation of carbon-emissions metrics at portfolio level. The standardization of a selected carbon emissions metric makes the process of potential transfers across data providers feasible, whilst maintaining the integrity of the carbon reporting.

Carbon reporting should be required on a regular calendar basis with provision for minimum standards around quality assurance.

Question 9

We propose that regulations require trustees to:

a) *set at least one target to manage climate-related risks for one of the metrics trustees have chosen to calculate, and to disclose those targets(s)*

b) *calculate performance against those targets as far as trustees are able and disclose that performance*

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

Do you agree with these proposals?

Aon response

Requiring trustees to set specific targets may be counter-productive. Instead, putting this forward as good practice or a useful way to monitor performance might be preferable over a statutory requirement. Trustees will want to consider all the quantitative and qualitative measures which will help inform where they are trying to get to. Where targets are set, however, we believe that trustees should explain the rationale for their choice of metrics and targets and should disclose this in their TCFD report.

We expect that what is considered "good" performance will vary around the metrics, and so a general improvement rather than aiming for specific targets might lead to better outcomes. As an example, setting targets which are easily achieved may not drive trustees to continue on that path and exceed the target set.

Question 10

We propose that, for all schemes in scope:

a) *the trustees should be required to publish their TCFD report in full on a publicly available website where the report is accessible free of charge*

b) *the trustees should be required to include in the Annual Report and Accounts a website link to the location where the full TCFD report may be accessed in full*

c) *the trustees must notify all members to whom they must send the annual benefit statement of the website address where they can locate the full TCFD report – this must be set out in the annual benefit statement*

d) *the trustees should be required to report the location of their published TCFD report to the Regulator by including the corresponding website address in their scheme return*

e) *the trustees should also be required to report the location of their published Statement of Investment Principles (SIP), Implementation Statement and excerpts of the Chair's Statement by including the corresponding website address or addresses in their scheme return*

Do you agree with these proposals?

Is there a better way to notify members of where to find this information?

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

Aon response

We agree that the proposals are broadly appropriate, and build well on the existing disclosure infrastructure to minimise additional costs to schemes. We also agree that extending the signposting to summary funding statements would make sense, to include members with defined benefits who would not necessarily receive an annual benefit statement. This could be in addition to the listed requirements.

It would also be good practice to include links to this information in any newsletters, or summaries of a scheme's report and accounts, which are sent to members. However, as such communication is not obligatory, this should not be a legislative requirement.

As noted in our answer to question 5, our one concern is that there may be occasion on which a scheme's TCFD report could contain confidential information – for example on the impact of climate change on the employer. It may be helpful to include provision for confidential information to be omitted from the report made available to members and on publicly available websites, in certain circumstances.

Question 11

We propose that:

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

Do you agree with this approach?

Aon response

We believe this to be a reasonable approach. Some disclosure, even if incomplete, is better than none at all, and we believe that this approach will encourage disclosure.

However, clarity from TPR on what disclosures it would deem "inadequate" would be helpful. In our experience, aligning a trustee board's governance processes to the TCFD is an iterative process, involving some trial and error, which takes time to fully embed itself into a board's governance framework.

TPR can encourage trustee boards to positively engage with this process whilst allowing trustees some time to remediate problems as they arise. While monetary penalties are one tool for doing so, we believe that clear guidance, combined with flexibility in its application, can be more effective.

Question 12

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

Aon response

The policy proposals will require careful thought and planning by trustees, but we believe that the regulatory burdens are proportionate given the potential benefits and, conversely, the potential damages if left unaddressed.

Question 13

Do you have:

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

Aon response

We do not have any further comments on the proposals.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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