BAE Systems Pension Funds Trustees Limited
Warwick House, PO Box 87
Farnborough Aerospace Centre
Farnborough, Hampshire
GU14 6YU United Kingdom

T 0800 917 9568
F 01252 378660
www.baesystems.com/pensions

BAE SYSTEMS

Reply to DWP Consultation:

Taking action on climate risk:

Improving governance and reporting by occupational pension schemes

9 October, 2020

Dear Minister

I am Chair of the Trustee of the BAE Systems Pension Scheme and I am replying on behalf of the Trustee, having consulted with our advisers.

We welcome the DWP's consultation on mandating the Task Force on Climate-related Financial Disclosures' (TCFD) reporting requirements for pension schemes. We are grateful for the opportunity to respond and I apologise for the late submission of this letter.

The focus on climate change risks is welcome. We are encouraged that this consultation addresses the specific actions that pension fund trustees might be expected to take in their climate change risk understanding and approach. Before new requirements are placed on trustees it is important that proper account is taken of trustees' existing duties and obligations to act in the interests of their beneficiaries and to comply with existing law and regulation. Climate change risks are important; other financial and non – financial risks are also important, as is the duty to act in members' interest and to seek to meet the trust objectives to pay/maximise pensions as promised.

We would welcome the opportunity to engage further as DWP's thinking evolves. On a topic as important as this, a practical approach designed to help us deliver genuine improvements in our approach to addressing climate – change risk and opportunities, is a real prize to be won. If we can support the discussions as this work continues we will pleased to do so.

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?

This approach has the benefit of clarity and reasonable simplicity: bearing in mind the different types of Scheme in existence, is there a risk that such a clear – cut approach may have any unintended consequences? For example asset thresholds are vulnerable to fluctuations in asset value.

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?

The timings proposed may be too ambitious, particularly if the full regime comes into effect all at once. All pension schemes should already be considering ESG factors, including climate related factors, into their governance, investment (and funding for DB) strategy and risk management processes. A governance regime already exists for that, albeit one that is likely to evolve. Given, the materiality of climate change for pension schemes, as noted in the consultation document, we accept the proposal to develop an additional requirement to manage climate risks and opportunities and to disclose trustees approach in line with TCFD recommendations. However, we would stress that, even with specific guidance, consistent and best practice TCFD reporting will take time to develop. A degree of realism will be necessary in the early years of reporting, as the climate risk information required is either incomplete or unavailable from asset managers. The same is true for the businesses they invest in. Aligning requirements across the investment universe is necessary and will take time. We also note that the methodologies for analysing these risks/opportunities are new. They carry risks, e.g. in how they are applied in practice and in how accurate they are; they may inadvertently encourage counterproductive behaviour. We would therefore encourage greater clarity in this area and support in helping trustees comply with any new regulations

One possible approach might be to introduce the new requirements without penalties, to operate as a 'pipe cleaner' for Schemes and the regulator, to help establish a set of 'norms' in terms of what it is reasonable to expect in the early days and reasonable to aspire to over time (taking into account the proposed 2024 review). This would allow Schemes, the regulator, advisers and other stakeholders to develop a deeper understanding of the challenges and opportunities presented by the new regime.

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?

We agree that a review of any regulations and statutory guidance in 2024, with a view to them being improved, is a good idea

Any such review should be conducted without any assumption that the regulations and statutory guidance should be 'strengthened or updated' or retained: the question should concentrate on whether the purpose of the regulations/statutory guidance is being achieved and should draw not only on the learning from the regime's operation, but also on that of climate–change management compliance regimes being established across the wider investment and corporate universe, in the UK and elsewhere.

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?

These proposals will put climate – change risks/opportunities into a unique position in terms of how they are to be considered by trustees. Also, it is not clear if the proposals extend beyond management of investment/funding risk (e.g. is it intended that trustees consider the climate impact of their advisers or administrators or sponsors when making decisions in relation to such parties?). To work, clarity on the extent of the new duties being created and on their relationship with trustees other duties will be essential, to avoid any inadvertent breach of duties by trustees and to support trustees ability to comply both within the spirit and intention of the new regime, and also efficiently and effectively.

Trustees are generally not qualified to assess climate change risk. They will have to rely on professional advisers qualified to advise on such matters, so far as they exist. At this early stage in the process it is unclear how much proven adviser expertise there is in this area. When a new market is created and a flood of demand arises there is always a risk of opportunistic suppliers or simply of a shortage of suppliers which puts trustees in an invidious position. One would expect there to be different views on how organisations are managing their climate risk. It is important the regime allows for more than one 'right' answer.

Trustees will need to learn how to intelligently interrogate the advice they receive. They will need help to develop rigorous oversight and assurance practices and will need to have access to suppliers to implement them. All of this will take time and will be expensive. Clear and pragmatic guidance on how to approach this will be essential. The 'pipe-cleaner' suggestion referred to in our response to Q.2 above might work to help this requirement to evolve in a way that ensures we deliver on the objectives in a way that is reasonable for all concerned.

The proposal doesn't indicate any standard to which trustees must adhere. We presume that a reasonableness test will apply?

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?

This question is more focused on investment and funding strategy, unlike question 4 which appears to be more general in nature. To help trustees meet this requirement the statutory guidance should be detailed, clear and unambiguous. The trustees' duties should be as clear as possible and how the new duties align with trustees' other duties, including in respect of investment and funding strategy will need to be addressed. Schemes differ in their time horizons and while the ambition set by the consultation is commendable, trustees will need time to acquaint themselves with the new requirements and corresponding duties as they apply to their schemes. They also need time to assess and then select high quality professional advice to help them meet their new duties.

Some schemes have DB and DC elements (and hybrid elements). In DC there may be various default arrangements. We would suggest that trustees of such a Scheme like ours should be able to produce one response to this requirement, albeit that response might need to contain an annex to cover differences between the different elements of the Scheme. This would reduce repetition, overlap and work of no value.

The proposal does not indicate any standard to which trustees must adhere. We presume that a reasonableness test will apply? Note Q. 6 uses the term 'so far as they are able'. There is an almost limitless amount of analysis that could be done and this phrase would point to significant expenditure. Trustees will need legal advice to properly understand the extent of their duties and how to carry them out. As much clear and unambiguous guidance on this as possible should be provided to help trustees do a good job in meeting expectations.

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?

The statutory guidance will need to be detailed, clear and unambiguous, given the trustees limited role in the investment process. Will trustees' be given criteria by reference to which they will be required to adopt an investment strategy that takes into account their assessment? How will this align with their legal duties and obligations?

The use of a 2 degree or lower scenario is logical as it links to the Paris Agreement. We would welcome guidance/examples on what scenarios could look like for a 2°C world, for consistency between schemes. We suggest that the requirements include some flexibility to run the scenarios based on different limits if more recent developments suggest that would be more relevant. There should be a recognition that this is an evolving subject and that any scenario analysis is wholly reliant on the available data set. We ask that, in the light of the data challenge, regard is given to any timescales stipulated, perhaps introducing a phased approach so that trustees can build up the necessary knowledge and understanding of the scenario outputs. Again, the pipe – cleaner idea referred to above might help.

However, the very practical relevance and benefit of this proposal should be considered. The trustees do not pick stocks and may not know the content of their portfolios intimately. With advice they set the investment strategy and principles, with a view to paying the pensions. Will that requirement change? The underlying stocks across the Scheme's asset allocation change over time and any assessment will, presumably, have to take that into account. So the purpose and expected output of scenario testing should be clear to make sure it's an efficient and effective piece of work. The nature of the transition pathway is equally, if not more important than the ultimate temperature and this should be built into the scenarios used. For example, an orderly transition vs a disorderly transition would have very different impacts and could both arrive at the same end temperature.

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?

Detailed, clear and unambiguous guidance should be provided to help facilitate the trustees' understanding as to what it means in practice to effectively identity, assess and manage the climate change risks. Furthermore, we would encourage that all disclosures are applied in a consistent manner across all assets in scope.

Does this proposal address all climate – related risks, or only those that directly affect funding and investment? This proposal could require trustees to describe/disclose their approach to risk management generally – is that the intention? If so, guidance on how this should be done will be needed. A significant advice and assurance burden will emerge as a result.

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?

The use of at least one greenhouse gas (GHG) emissions-based metric and at least one non-emissions-based metric appears to be a sensible approach to assess a pension scheme's assets against climate-related risks and opportunities. A possible default metric could be weighted average carbon intensity (WACI). There needs to be robust evidence on the accuracy and availability of this data.

As for timescales, quarterly monitoring of any metrics seems unrealistic in so far as the underlying data from investee companies is commonly taken from their annual reports and hence will not be updated quarterly. Further investments may well involve investees overseas and in markets (public or private) where disclosure obligations are different. Furthermore, it should be seen in the light of the long term nature of the scheme's investments. How should a petroleum company with sincere aspirations to be carbon neutral in the future be evaluated?

With regard to d), we believe that guidance should acknowledge that there will be, in the short term, data gaps which as a result will hinder a full and qualified assessment of certain asset classes that the pension scheme is or intends to invest in. Even today, where data is disclosed by investees there continue to be arguments about its efficacy (witness the recent controversy in respect of HS2 carbon emissions). The standard to which trustees will be held in this regard should recognise these challenges.

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?

Trustees will need the statutory guidance in relation to targets to be detailed, clear and unambiguous. A few thoughts/queries: are targets expected to be met? Would it be sensible to adopt a base target and a stretch target (one that trustees should expect to meet; one that they should aspire to meet)? How does a requirement for a target interact with/affect trustees other duties in relation to the Scheme and its members?

To be credible trustees will need to ensure there is a robust evidential basis to prove that a target is being met, that it is achieving the desired outcomes and not leading to perverse consequences (we do not want a repeat of the diesel story).

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?

Pension schemes are not public trusts or public bodies and there should be no requirement to disclose publicly. Disclosure to the wider public is an invitation for those without an interest in the trust to try and influence trustees and members.

A requirement to disclose to members (or the Pensions Regulator) on request is appropriate. Experience suggests that members have a limited enthusiasm for reading scheme information, of which there is an increasingly large volume. We see no evidence of demand from members for this.

The DWP may wish to survey schemes to see how many downloads or requests for documents are made under the existing regime to gauge members' appetite.

If the proposal to disclose to the public is retained (and we disagree with it) it should be on the basis that the trustees have no duty or liability to the public and that they could face no loss as a result of such publication.

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?

Instituting financial penalties and naming and shaming will increase compliance and assurance costs for schemes and will probably drive the market towards identikit TCFD reports that ensure compliance with the regulations and are very long and cautious but of little substantive value. It will be an environment unlikely to stimulate the imaginative thinking that is necessary to evaluate climate risks for pension schemes and support the outcomes desired.

Trustees (particularly those of schemes in the scope of these requirements) take their responsibilities very seriously. Perhaps the greater risk is that trustees focus on this to such an extent that other risks are squeezed out.

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?

We are supportive of the idea that pension schemes explicitly take into account climate change financial risk. It should be made clear whether or not Schemes are then expected to give such risks precedence in establishing and implementing investment strategy. Trustee duties should be explicitly changed if this is the expectation. The costs involved in meeting these regulations will undoubtedly be burdensome in both financial and time terms: covering for example, report creation, setting up the appropriate systems and controls, verification and audit processes, the use of consultants, experts and advisers; the interaction with the regulator and dealing with potential breaches and liability. Are the experts available to support trustees? If investee businesses are required to disclose climate related data then schemes amalgamating this does involve an element of duplication of effort.

The estimates for costs given in the consultation are likely to be a significant underestimate. Experience from other regulatory initiatives shows that the impact assessments tend to underestimate compliance costs many times over, and, bearing in mind the complexity of the TCFD requirements they are underestimated here too.

The DWP may find it helpful to check its methodology for estimating costs against real life experience of pension schemes, small and large.

The impact of these proposals on corporate sponsors needs consideration. Schemes and their sponsors are intimately linked and their reputations are bound together. Trustees will need to interact with their sponsors (who are likely to bear much of the cost of compliance) and take into account the duties, obligations and expectations that sponsors may have in relation to the matters covered by these proposals.

Stewardship can play an important role in ensuring that investee companies are adapting to climate change transition. For this reason we would advocate greater engagement to encourage companies, both public and private, to align with the TCFD framework. Perhaps there should be greater alignment between this consultation and the 2020 UK Stewardship Code.

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?

When considering climate – change risks and opportunities account might also be taken of the impact on communities affect by changes in investment strategy. A wholesale, prompt disinvestment (and we note the Minister has not been in favour of disinvestments generally) from oil & gas would have a profound impact on a city like Aberdeen which may generate widespread public disaffection with the regime. Considering the unintended consequences of this initiative may give pause for thought. For example these oil and gas resources may be bought up by private companies with no pressure or desire to manage climate change risk. The net result being greater climate change risk, public disaffection and a smaller pool of pension scheme assets.

It should be possible to make information available to those who need it in alternative formats (e.g. by way of video, pod – cast, braille).

The proposals, if adopted, will add to the already significant body of requirements which Trustees have to satisfy. It is increasingly necessary to consolidate, simplify and tidy up the regulatory burden. If we have understood the proposals properly it is quite possible that substantially similar material will need to be included in the TCFD, SIPs, Chairs Statements, and Implementation Statements. Is this sensible or appropriate? It is certainly expensive, very time - consuming and, arguably, wasteful. Does all this material benefit members?

The proposals do give rise to the question of Trustees duties and obligations, as described in our responses. This is a key consideration for trustees and those who might consider becoming trustees in the future. Clarity in this area is essential and a declaration of the Government's intentions for the future of trusteeship would be welcome.

Signed on behalf of the Trustee, BAE System Pension Funds Trustee Limited:

Mr. Andrew Gallagher

Chair of the Trustee of the BAE Systems Pension Scheme