TAKING ACTION ON CLIMATE CHANGE: DWP CONSULTATION

7th October 2020

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Bethan Livesey, Tom Rhodes, Andrew Blair, and David Farrar
Climate Governance and Environmental Social Governance (ESG) team
DWP
Caxton House
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London SW1H 9NA

7 October 2020

Dear Bethan, Tom, Andrew and David

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

Redington Ltd is delighted to respond to the above consultation. We are broadly supportive of the proposals set out in the consultation and welcome the increased focus on climate risk for pension schemes. We agree that better disclosure will lead to better decision-making and better outcomes for pension scheme members.

Redington is an independent consultancy based in London. We advise a range of long-term investors, including DB, DC, private wealth and insurance clients. Our mission is to help make 100 million people financially secure.

Yours sincerely,

Carolyn Schuster-Woldan & Edwin Whitehead

Q1: 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?

We agree with the proposals. We note that some authorised master trusts have considerably less than £1bn in assets, so there is a discrepancy in the proposals with requirements for single employer trusts.

Q2: 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?

We broadly agree with the proposals.

We do however have some concerns around the timing of the first report for some larger schemes who may not have engaged with TCFD requirements to date. Our experience suggests that the timeframe will be tight to carry out the work needed to align with the recommendations of the TCFD. The consultation is clear that it is action, not reporting that is important, and this action will take trustees time to work through. Until the quality of the statutory guidance that will accompany the regulations is confirmed, it is tricky to opine on the intention to conform smaller and less resourced schemes to align with the recommendations of the TCFD. With limited governance budgets, we would not want trustees to reduce focus on other, also important risks affecting their schemes, such as covenant, funding or other investment risks.

The statutory guidance will need to be both detailed yet accessible if this regulation is to drive real change in climate risk-management while simultaneously not distracting trustees from their work in delivering the other various objectives of their respective schemes.

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 £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 do agree with the proposal to conduct a review of how disclosures have been adopted by larger schemes in 2024. Schemes that are over £1bn in assets will have had, as a minimum, one reporting cycle by 2024 (larger schemes will have had at least two) so there should be useful lessons to be learned. Without sight of the statutory guidance, however, it is hard to judge at the moment how much these requirements will lead to "real world" actions which lead to changes towards a lower carbon world, rather than a "tick box" exercise which just leads to an increased regulatory burden.

Q4: 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?

The regulations lift the wording out of the TCFD recommendations, so it is very helpful that they are aligned in that way. However, without sight of the statutory guidance which will show what these might look like in practice, it is difficult to lend whole-hearted support. We are confident that the industry will adapt and develop best practice, but the statutory guidance needs to be presented for consultation as soon as practicably possible.

Q: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.

> ## Box 4: Statutory Guidance on Strategy
>
> In identifying and assessing the impact of climate-related risks and opportunities on the investment and, in the case of DB, funding strategy of the scheme over the short, medium and long-term, we propose statutory guidance would set out the following matters to which trustees must have regard:
>
> - the levels at which the identification and assessment of risks and opportunities should be carried out - for example, the individual sections of a scheme with DC and DB sections – as well as additional analysis that could be carried out, for example, in relation to different asset classes
> - how to understand and assess the scheme's climate risks and opportunities across short, medium, and long-term time horizons
> - examples of climate-related risks and opportunities that could have a material financial impact on scheme assets
> - definitions to help trustees understand whether the climate-related risks are transition or physical risks
> - examples of the factors trustees might consider to determine which risks and opportunities could have a material financial impact on their investment strategy and funding strategy
> - guidance on how climate-related risks and opportunities could be factored into their investment strategy and funding strategy and the implementation of those strategies
>
> Statutory guidance would also set out that trustees should describe in their TCFD Report how they have approached each of the matters above.
>
> Where they choose to deviate from the approach set out in the guidance, trustees would be expected to describe the reasons for doing so in the relevant section of their TCFD Report.

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

Do you agree with these proposals?

We agree with these proposals. As with the answers to previous questions, given that statutory guidance will cover these matters we believe that it is important that the statutory guidance is published as soon as possible. Guidance on how trustees are expected to define short, medium- and long-term time horizons would be welcomed.

Q6: 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?

We are supportive of the proposal to require pension trustees to carry out climate-related scenario analysis as an effective risk management tool. We commend the proposal's call to use at least two scenarios, one being below 2°C, noting that the two scenarios should include different climate risks (whether that is transition or physical).

On the point of hybrid schemes, we endorse the recommendations that scenario analysis should be carried out at the individual section level for both DB and DC. However, we raise that this should be done on a proportionality-basis, noting that some hybrid schemes have much larger DB than DC sections and Trustees have limited ability to change the asset allocation of the DC sections. We believe that the inclusion of scenario analysis case studies, especially on DC strategies, in the statutory guidance would be highly welcomed by the industry.

While we commend the use of scenario analysis, we also offer caution around the efficacy of performing complex scenario analysis. The requirement to produce scenario analysis could take up a lot of time and while it can give an indication of materiality, often its results simply confirm common sense (i.e. equities have higher climate-related risk than long dated investment grade credit) without leading to changes in investment decisions. Therefore, statutory guidance should be clear about how this exercise helps schemes make better investment decisions while being flexible enough for schemes adopting a more simplistic, qualitative approach.

The requirements to extend scenario analysis beyond the investment strategy to the funding strategy for DB schemes may also create additional layers of complexity. We understand funding strategy to be the interaction of the investment strategy, liability profile and sponsor covenant. For a Trustee to carry out scenario analysis on the liability profile would require the scheme actuary to calibrate longevity and mortality assumptions to different climate pathways. We suggest guidelines clarify this requirement from an actuarial valuation process perspective.

Any underlying assumptions that impact the actuary's assessment of the scheme's liabilities may require comprehensive consultation and analysis between both the Trustee and their advisers, and the Trustee and the corporate sponsor. This process happens every three years as part of the triennial actuarial valuation. Requiring this to happen every year may be an onerous task that trustees could struggle to resource. It would also require actuarial input. Instead, we suggest consideration of including this assessment alongside the triennial valuation reviews. Climate-related risks can be measured on an annual basis via the reporting of the chosen metrics (Q8) and triennially by performing scenario analysis as it is unlikely that material changes will be observed in these assessments' year-on-year.

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 above.

Do you agree with these proposals?

We are supportive of the proposal for schemes to integrate climate-related risk identification, assessment, and management processes into their overall risk management process.

We are currently working with several clients on building out climate risk management frameworks that are embedded within their existing risk management processes. Embedding climate-related risks into existing frameworks is a more effective way of managing these risks than establishing completely new, standalone processes for climate considerations. A benefit of building climate-related considerations into an existing framework is that materiality can be assessed on a relative basis against other risks the scheme faces. Climate change risk is not the only risk schemes face across different time horizons and as such, the management and required disclosure should be proportionate to the materiality of the risk to members’ financial outcomes.

- *Risk identification should be done at a high-level not at specific, individual risk level. Schemes should assess materiality based on physical/transition risk not at a more granular level as suggested by the proposal. Currently investors are not in a position to be able to value individual climate risks and attach an estimated potential loss figure to each of the risks identified.*
- *Working with several clients on this, we believe there will be a disparity of approaches to doing this for different schemes. For example, smaller schemes might outsource climate risk management to active managers – as they do with other types of risk. The statutory guidance should reflect this and not be overly prescriptive.*

Q8: 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?

We support the proposal to require trustees to disclose two metrics as this will be useful in establishing some consistency across the industry. We believe assessing the usefulness of one metric over another should be part of climate governance and we encourage DWP to consider requiring an explanation as to why schemes have selected a chosen metric. We see considerable value in the statutory guidance offering advice on the technicalities of choosing one metric over others.

We caution that the proposed frequency of monitoring metrics on a quarterly basis is quite onerous and could lead to short-termism. Guidelines should make clear that whilst selected metrics should be reviewed periodically, (including a clear indication of what is meant by this review) changing metrics regularly is not in the best interest of trustees as meaningful improvements will take time. We also note that quarterly measurement against targets is a challenge from a data provision perspective as corporate reporting of carbon data is done on an annual basis. This brings into question the usefulness of trustees monitoring these metrics on a quarterly basis where the data may effectively be unchanged.

- *We also note that current data availability is very much based on backward-looking metrics whereas industry best practice for climate risk management is increasingly forward-looking/alignment-driven in nature. As such, we raise our concern over unintended consequences (i.e. backward-looking metrics such as portfolio level carbon emissions could go up before they fall over the first few years while forward-looking metrics such as "Paris-alignment" improve as the portfolio gets closer to aligning with global climate goals).*

We are comfortable that the proposal adequately recognises the problems associated with collating the required data. Data availability is inconsistent and work is often required to ensure the data is ready for use in reports. We think this should not be an undervalued challenge.

- *From a carbon accounting perspective, guidelines should make clear whether:*

  a) the scheme should view itself as an entity and therefore disclose scope 1 and 2 of their operations if material (which is likely to prove burdensome) alongside scope 3 financed emissions which encompasses scope 1 and 2 emissions of the companies underlying the debt or equity investments, or

  b) the scheme should solely focus upon financed emissions which can be viewed as just the scope 3 emissions of the scheme (including scope 1,2,3 of the companies underlying the debt or equity investments).

If it's the latter, we would raise caution around data availability and double counting. Schemes might not be able to collect scope 3 data of underlying companies due to limited disclosures in this scope. Also, including underlying companies' scope 3 in financed emission calculations might encounter material double counting. Guidelines should make it clear what is meant by each scopes of emissions – this needs to be a clear focus of any educational material produced.

The proposed statutory guidelines recommend "calculating GHG emissions in line with the GHG Protocol methodology", however simultaneously noted that the principles have limited applicability for pension funds. We suggest the guidance makes clear what carbon accounting practices pension trustees are expected to adopt. If possible, we recommended guidelines provide carbon accounting examples and case studies to guide trustees.

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 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?

We agree that targets can be an important element of managing climate-related risks and opportunities and can be a mechanism through which trustees can set a path for the schemes' strategy. However, we caution that by requiring schemes to set targets against one of the metrics they report on from the first year of disclosures, there is a risk that these targets will be premature and will be disconnected from investment objectives. It is likely that less prepared schemes will set targets for the sake of setting a target and not because the target is meaningful and will help schemes meet their investment objectives. We think there is value in taking a phased-approach to setting targets as this will allow schemes to identify meaningful and achievable targets.

Echoing our response to Q8 on the quarterly measurement element of the proposal, we think this has a risk of mandating short-termism and unintended consequences. Requiring annual targets to reduce emissions intensity (which is a backward-looking metric) may lead to sub-optimal investment decisions overall and a less than desired alignment position in the longer-term.
We propose that the proposal looks to other industry best practices and developments in this area. For example, the IIGCC's Net Zero framework, which "aims to avoid an approach to target setting that incentivises investors to take actions that reduce their impact simply to meet a specific number in a given year".

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 full TCFD report may be accessed in full

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

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

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

Do you agree with these proposals?

We agree with these proposals as they align to existing disclosure duties and processes for trustees. Over time, it would be good to see trustees and pension schemes introducing more modern means of informing members about the existence of these important document. For example, email or SMS notifications.

Q11 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?

We agree with this approach but note that other guidance in this area allows trustees to take a proportional approach. Once smaller schemes are in scope, it will be important to define what "inadequate" TCFD reports are.

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?

We believe that the costs of pension schemes reporting in line with TCFD has been vastly underestimated. We recommend that a survey of industry participants is completed after the first year asking what the actual costs have been in terms of additional trustee, consulting and asset manager time to ensure that value is being derived from the additional governance, strategy and reporting commitments.

Q13: Do you have:

a) any comments on the impact of our proposals on protected groups and how any negative effects may be mitigated?

b) any evidence on existing provision made by trustees in response to requests for information in alternative accessible formats

c) any other comments about any of our proposals?

We have no further comments.

CASE STUDY – COST IMPACT

The main body of this case study is drawn from a cost impact request from the DWP that Redington responded to in May. The objective of this request was for the DWP to gauge the total cost impact of aligning with the recommendations of the TCFD for pension schemes. We are keen to confirm that our cost estimates for investment consultancy work are unchanged.

We believe there will be two sources of costs for schemes that are required to align with TCFD:

1. **One-off set-up costs:** working with the trustees/investment committees of pension schemes to provide TCFD training and to align their practices with the four pillars of TCFD.
2. **Ongoing reporting:** this will be the annual cost of producing the report (including stress tests, data from investment managers, and reporting on the other TCFD pillars).
   - As the third-party cost for providing climate-risk-related data for investment managers will be charged per manager, we have shown different indicative costs for illustrative schemes with varying numbers of managers.
   - We have presented these estimates as ranges as there are a number of underlying variables which will likely impact the cost to produce, e.g. underlying asset classes, geographies etc.
   - The cost is also related to the governance requirements of each pension scheme. Schemes with more complex portfolios and higher governance budgets would likely require more in-depth analysis and corresponding risk management approaches.

We have projected the costs that we would charge for clients of £1bn total assets, given the current guidance which we have been asked to opine on does not contain a fixed date for when TCFD alignment may become a requirement for schemes below that size.

This breakdown can be found overleaf.

What is included in the costs?

TCFD set-up:

- This is an estimate of the cost of us, in our role as an investment consultant, providing initial "set-up" sessions. This would be to work with the trustees/investment committees of pension schemes to begin aligning their practices with the four pillars of TCFD.
- The cost estimate is for a relatively light touch process for a pension scheme that is looking to better integrate climate-risk management, but not move towards best practices or explicit alignment with the Paris Agreement.
- To deliver meaningful benefit and avoid boilerplate statements, we believe this project should be undertaken for all schemes wishing to disclose in line with the recommendations of the TCFD. As the TCFD framework is based on how to disclose, we do not believe it is beneficial to disclose where action is not being taken.

Reporting:

- The reporting cost depends on the number of investment managers and whether they are able to provide data and disclosures themselves.
- We estimate a cost of £1,000 per fund to source and analyse manager data and use any corresponding third-party data providers (e.g. MSCI, FTSE Russell).
- We estimate a cost of £5,000 per annum to write, review and format the report.
- An estimated breakdown of a 'Year One' TCFD project is provided below:

	Scheme 1: low number of managers	Scheme 2: medium number of managers	Scheme 3: high number of managers
TCFD set-up		£25k - £45k	
Reporting (cost p.a.)	£7.5k - £10k	£10k - £15k	£15k+
Total year-one cost	**c.£35k**	**c.£45k**	**c.£65k**

Year Two onwards:

Aspect	Estimated cost
Detailing and disclosing the Scheme's procedures around climate-related risks and opportunities	Production cost per annum £5k assuming no change to approach over the period.
Conducting, detailing and disclosing Scenario Analysis	£10k - £17k
Calculating, detailing and disclosing Metrics & Targets	Minimum £1000 per manager/fund

Aspect	Estimated cost
Any other elements of completing and commenting on activities around TCFD matters	Examples have included: mapping exposures to businesses covered by Transition Pathway Initiative (TPI), reviewing CA100+ exposures and integrating support into engagement strategy, reviewing individual manager climate scenario approaches. Cost has been high to date due to lack of standardised data, however this is expected to fall in the future. We do not expect one of these individual projects to exceed £15k p.a. on a case-by-case basis.