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

**Willis Towers Watson consultation response – October 2020**

*For the attention of Bethan Livesey, Tom Rhodes, Andrew Blair, and David Farrar*

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I am writing on behalf of Willis Towers Watson (WTW) in response to the consultation "Taking action on climate risk: improving governance and reporting by occupational pension schemes".

We very much appreciate having the opportunity to respond to this consultation, and also welcome the ongoing engagement between WTW and the Department for Work and Pensions (DWP) in this important area. In particular, we look forward to seeing the results of this consultation as well as the final proposals and statutory guidance in due course and we would be happy to discuss these further as appropriate, including as part of the wider UK Green Finance Strategy.

For clarity, our response below includes both general comments and context as well as answers to the specific consultation questions as labelled.

**Overall views and context**

Willis Towers Watson Investments is clear in its purpose of 'investing today for a more sustainable tomorrow' and in our conviction that sustainable investment is central to successful long-term investor outcomes. In particular, we believe that climate change is a systemic and urgent global challenge that necessitates specific risk management, opportunity identification and collective action. Please refer to our Sustainable Investment Policy for further detail on our position and activities in this area.

Against that background, we are very supportive of the TCFD and its recommendations, and view them to be an important part of how the investment industry can appropriately address climate-related risks and opportunities.

We are mindful that increased and improved TCFD reporting for investors must be appropriate and reasonable in the context of the organisation reporting, and that it is of value when it leads to better investment decision making and action.

Further we recognise that pension schemes have an important and influential part to play within a well-functioning investment system, but note that they are reliant on other organisations playing their parts too. This includes for example ensuring there is an appropriate availability and flow of accurate information, and therefore we note the need for a joined up regulatory regime to avoid one group of organisations bearing an undue burden.

With this context, we support the majority of the proposals outlined in this consultation, and in particular are supportive of the overriding principle of trustees addressing climate change risks and opportunities through effective governance and risk management measures, and disclosing these appropriately to their key stakeholders.

We do outline below some areas of potential concern, mindful particularly of any unintended consequences or undue burden being placed on trustees. In this regard, we would particularly highlight:

- The effective cost to schemes of these proposals – in broad terms of governance, resources and explicit costs in areas such as data – is significant, and in our view, significantly higher than currently outlined. This is on the assumption that the work conducted to support TCFD reporting (in terms of scheme governance, analysis, monitoring, etc.) is done in an engaged and thorough way, rather than just to facilitate 'tick-box' style regulatory reporting. We are strongly of the view that there is positive value to be realised through an engaged and thorough approach, but note that this requires a significant investment of scheme time and resources (including via third parties). If a minimum cost and compliance-style approach is adopted, we believe there is significant risk that TCFD reporting acts merely to add a regulatory burden, which would be a poor outcome for all stakeholders.

- Of the main recommendations of TCFD, metrics and targets are those which have – in our experience – often been most challenging to trustees thus far. One concern in particular, beyond challenges of data and accurate monitoring, is that inappropriate metrics and targets, measured over inappropriate time horizons, could lead to unintended incentives and action.
    - In part this recognises that climate change is one of many risks and challenges that pension schemes face and that trustees must balance appropriately in the context of their respective schemes. Therefore, climate needs to be treated with proportionality (which, to be clear, goes both ways), and also applied on an integrated basis as part of the scheme's ongoing risk management and overall funding strategy.
    - It also recognises that pension schemes are part of a wider financial and economic system, and that the outcomes schemes are able to deliver to their members are closely tied to the health and resilience of the system as a whole.
    - We are cautious around setting requirements that could lead significant numbers of market participants to optimise their individual strategies around a small number of imperfect measures with short-term horizons, leading to wider unintended consequences. For example, a focus on optimising emissions intensity could lead to investors replacing fossil fuel production exposure for increased fossil fuel value chain exposures. Put another way, lower reported emissions intensity may not mean lower climate risk. Also, a focus on current carbon emissions may mean investors avoid investments in companies or assets looking to provide climate solutions in higher emissions sectors. Further, individual scheme targets (and actions taken to help meet them) may not appropriately address the systemic risks involved, and potentially pass direct ownership of some risks to investors less able or willing to address them.
    - We would support using a dashboard or balanced scorecard of climate metrics and targets, that includes reference to the level of systemic risk, and integrating this within the overall risk management and operations of the pension scheme.

**Scope and timing (questions 1-3)**

On balance, we agree with and are supportive of the proposed approach in these areas.

We note that it may be a tight schedule for some schemes (dependent on individual scheme year ends) to report by the 31 December 2022 deadline where applicable, however we believe there is sufficient flexibility in the proposals and reporting expectations to make this manageable for those schemes which are most impacted. Also, on balance, we support the proposed tiering and staggering of reporting for schemes of different sizes, noting that size can act as a proxy for scheme governance which has in our experience been the most significant determinant of effective engagement with climate change thus far.

We would also highlight that several schemes have already engaged with the TCFD recommendations and produced TCFD reports, which not only shows what is already possible, but also can act as a guide and help to schemes who are less far along this journey. This is in addition to existing industry guidance (such as that produced by the Pensions Climate Risk Industry Group) and the further statutory guidance referred to in this consultation.

We are supportive of the proposed review in 2024.

**Governance (question 4)**

We are supportive of these proposals and note in particular the importance and centrality of effective governance for pension schemes. We would highlight and agree with the notion that appropriate identification and management of climate risks and opportunities is fully aligned to trustees' fiduciary duty, and should be a core part of trustee scheme oversight.

**Strategy and scenario analysis (questions 5-6)**

We are supportive of these proposals, but note that these requirements should be applied with particular attention to proportionality to reflect individual scheme circumstances. This includes schemes where climate-related risks and opportunities are reasonably considered less material, as well as those schemes where these risks and opportunities are amongst the most significant to the scheme's continued operation and funding strategy. In this latter case for example, we would include schemes where the covenant strength is heavily tied to climate risk. As such, we highlight the need for climate risks and opportunities to be considered across the whole of the pension scheme on an integrated basis. We believe this point should be clearly emphasised in the finalised proposals and statutory guidance.

A further point in respect of covenant analysis and disclosure is that we would want to ensure that trustees and sponsors are able to engage constructively in this area, and would want to avoid covenant conversations being limited in their scope and usefulness for fear of public disclosure requirements around commercially sensitive information.

We recognise that scenario analysis is very important and well-suited to considering climate risks and opportunities given the level and nature of uncertainties involved. We welcome that the proposals are not prescriptive in terms of scenarios to be used, and indeed would strongly suggest that this remains the case, noting the benefits we have observed that this brings in terms of the depth of trustee engagement with and interrogation of the scenarios employed. Our experience has also suggested the benefit of scenarios that look across the scheme on an integrated basis – covering assets, liabilities, funding and covenant where appropriate – and also combining top-down and bottom-up analysis to give the fullest and most informative perspectives.

However, it is important to emphasise that scenario analysis should not be an end in itself, but it is the 'so what' and link to portfolio actions that is critical. This underscores our previous point that the value in TCFD reporting most often lies in thorough engagement with the work done to facilitate that reporting, and that disclosure should not be seen as an end in and of itself.

We understand the rationale behind the proposal that scenario analysis is conducted annually, however, on balance we would support the exercise being done less often (perhaps aligned to a triennial cycle as per other significant elements of scheme strategy), provided that it is done with sufficient depth and engagement. Moreover, trustees may be able to engage during this triennial cycle with specific elements or areas of focus highlighted by the scenarios, as we would not advocate for a 'set-and-forget' type approach.

In our view this longer time interval for scenario analysis would facilitate a greater depth of engagement with the scenario analysis, a stronger link between the analysis and other strategic scheme issues, and reflect a more realistic appraisal of the strengths and weaknesses of scenario analysis. Changes to experience or climate policies for example may be best captured in the relative likelihood or weighting accorded to different scenarios, rather than in re-formulated scenarios themselves.

**Risk management (question 7)**

We are supportive of the proposals, and in particular for the integration of the process within the scheme's overall risk management. We would underscore the importance of schemes not viewing climate risk – or indeed sustainability more widely – as a separate or isolated issue from the other risks that schemes have to manage. In this context, we believe it is important that climate-related risks and opportunities are not artificially over-weighted at the expense of other ESG or sustainability issues – or indeed other pension scheme risk management issues more widely – as well as the converse of them being unduly downplayed. As also noted earlier, we fully support that consideration is not just applied to the scheme's assets, but the scheme's overall operations and funding strategy as a whole.

**Metrics and targets (questions 8-9)**

On balance, we believe that metrics and targets can be important and valuable tools in the effective management of pension schemes. However, we note that too great an emphasis on individual metrics or targets, particularly when measured and monitored on a short-term basis, can lead to unintended consequences and/or inappropriate actions. We have noted some examples of this above, including where a metric or target does not fully capture the underlying risk it is intended to measure, and the limitations of metrics applied at an individual scheme level to appropriately reflect systemic risks.

As per our comments on scenario analysis above, we would recommend that targets in particular are more closely aligned to the time horizons of the issues they concern, and therefore believe that the emphasis on quarterly monitoring may be inappropriate. The reasons behind this include that short-term variations in metrics and performance may largely be determined by actions beyond the immediate control and scope of trustees, and therefore judging performance (which may then encourage remedial action) on this basis could lead to inappropriate and/or ineffectual action. This may also incur unnecessary costs (considering both transactional and governance costs).

In terms of the metrics proposed, we are mindful that any suggested metrics, including those highlighted as examples within statutory guidance, are likely to gain significant prominence. We also note that the encouragement to adopt "at least” a certain number of metrics could be repositioned as positively advocating for a dashboard or balanced scorecard of metrics as the preferred approach which we would strongly support. In any case, we recommend extreme care over the selection of such metrics and targets, and wherever possible, alignment to recognised standards and frameworks with large-scale adoption and industry support. We would highlight the EU Technical Expert Group, the Institutional Investors Group on Climate Change (IIGCC) and Principles for Responsible Investment (PRI) as three such sources.

We note the references to Implied Temperature Rise (ITR) and Portfolio Warming Potential in the consultation. We are supportive of them *not* being included in the current proposals. We recognise both the difficulties surrounding these metrics as identified in the current consultation, as well as our view that there are other metrics which will likely better support trustees in effective scheme management, notwithstanding ITR’s strength as a communication tool.

**Disclosure and penalties (questions 10-11)**

We support the proposals on disclosure.

In respect of penalties, we note that the size of the fines proposed may not act as a significant financial deterrent, but rather the reputational risks associated with lagging peer practice and falling foul of scheme comparisons (‘naming and faming’ or ‘naming and shaming’) may act as the more powerful motivators for action. We see merit in the Pensions Regulator having meaningful discretion over the application of penalties.

**Impact assessment (question 12)**

As noted in our initial comments, we believe that the costs to schemes of the proposals – particularly where schemes meaningfully engage with the recommendations of TCFD rather than simply look to complete a tick-box style report – are significantly higher than those outlined in the consultation. It is our strong conviction that schemes should engage meaningfully with the TCFD recommendations and that there is significant positive value in them doing so which would far outweigh the costs involved (taking ‘costs’ in the wider sense beyond explicit cash outlays). Nonetheless it is important to recognise up front the amount of governance, resources and spend required for the vast majority of schemes to effectively understand and manage the climate risks and opportunities to which they are exposed.

Given that we see significant *net* benefit for the vast majority of schemes in this area, this observation does not in any way diminish our support for the proposals, but it is nonetheless important to highlight.

**Protected groups, accessible information and further comments (question 13)**

We have nothing further to note here.