Regulatory Policy Committee

Climate Change Risk – Governance and Disclosure Requirements (Pensions Act 2021)

Lead department	Department for Work and Pensions
Summary of proposal	Mandatory climate governance requirements for large and medium-sized pension schemes. The requirements cover areas such as strategy & scenario analysis; risk management; and metrics & targets.
Submission type	Impact assessment (IA) – 1 April 2021
Legislation type	Secondary legislation
Implementation date	1 October 2021 and 1 October 2022
Policy stage	Final
RPC reference	RPC-DWP-5060(1)
Opinion type	Formal
Date of issue	30th April 2021

RPC opinion

Rating[1]	**RPC opinion**
Fit for purpose	The Department has used consultation to strengthen its evidence to support a slightly increased EANDCB figure.

Business impact target assessment

	Department assessment	**RPC validated**
Classification	Qualifying regulatory provision (IN)	Qualifying regulatory provision (IN)
Equivalent annual net direct cost to business (EANDCB)	£6.2 million	£6.2 million *(2019 prices, 2020 pv)*
Business impact target (BIT) score	£31.0 million	£31.0 million
Business net present value	-£53.6 million	
Overall net present value	-£53.6 million	

[1] The RPC opinion rating is based only on the robustness of the EANDCB and quality of the SaMBA, as set out in the Better Regulation Framework. The RPC rating is fit for purpose or not fit for purpose.

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RPC summary

Category	Quality	RPC comments
EANDCB	Green	The EANDCB is based upon sufficient evidence and reasonable assumptions, and the assessment has been strengthened through consultation.
Small and micro business assessment (SaMBA)	Green	The proposal will affect only large and medium-sized pension schemes and any extension to smaller schemes will be subject to a review and consultation. The SaMBA could be improved by providing information on the size distribution of pension scheme providers affected by the proposals.
Rationale and options	**Satisfactory**	The IA provides a reasonable discussion of a non-regulatory option. The IA would be improved by discussing further the rationale for intervention so soon after existing measures have come into force.
Cost-benefit analysis	**Good**	The Department has used consultation to gather additional evidence and make its estimates more robust. The IA provides an illustrative assessment of potential benefits to scheme members.
Wider impacts	**Satisfactory**	The IA includes a section on ‘wider economic and societal impacts’, for example possible impacts on investment decisions. The IA would be improved by explaining why the proposal is not expected to impact significantly on trade, innovation and competition.
Monitoring and evaluation plan	**Good**	The IA sets out a commitment to undertake an early review in 2023 and describes the areas this will cover. There is also a commitment to consult further in 2023.

Background

The RPC issued an opinion on the enactment stage IA for the Pension Schemes Act 2021 on 11 February 2021.[2] That IA included an assessment (at annex K) of a measure added during the parliamentary passage of the Bill (and, therefore, not covered in the final stage IA produced for the Bill's introduction to Parliament) on 'Climate Change Risk – Governance and Disclosure'. The RPC considered the Department's assessment of that proposal to be sufficient for the enactment stage IA but noted that the Department would be submitting a final stage IA on the secondary legislation for EANDCB validation. This is the RPC opinion on that IA.

Summary of Proposal

The proposal will phase in mandatory climate governance by 2022 for large and medium-sized pension schemes. In Phase 1, trustees of all Occupational Pension Schemes (OPS) with £5bn or more in assets and The Pensions Regulator (TPR) - authorised master trusts and authorised schemes offering collective money purchase benefits will have to comply with the Task Force on Climate-related Finance Disclosures (TCFD) disclosure requirements from October 2021. In phase 2, all OPS with £1bn or more in assets will have to comply from October 2022. Once in scope, schemes would have seven months from their scheme-year end date to publish a TCFD Report. Phase 1 is estimated by TPR to cover approximately 103 pension schemes and approximately 42 per cent of all UK pension assets. Phase 2 is expected to increase the number of schemes in scope of the requirements to an estimated 351 schemes, covering approximately 71 per cent of all UK pension assets and 81 per cent of all UK members.

There are four core elements of TCFD: governance; strategy & scenario analysis; risk management; and metrics & targets. The Department expects little impact in relation to governance and risk management disclosures, given the existing fiduciary duty and other requirements in these areas. The most significant additional requirements relate to producing and disclosing the results of scenario analysis and information about metrics and targets adopted in line with the TCFD recommendations (see EANDCB section below).

EANDCB

<u>Evidence and data</u>

The EANDCB comprises three main impacts, each accounting for a cost of around £1.7-£1.8 million each year in steady state:

i) Reporting and disclosure of governance activities around climate-related risks and opportunities.

[2] RPC-4364(2)-DWP 'The Pension Schemes Act 2021', 11 February 2021.

ii) Producing and disclosing required scenario analysis in line with the TCFD requirements.
iii) Producing and disclosing the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

On i), cost estimates have increased significantly since the enactment stage IA for the primary legislation; the present IA reports that consultation feedback from stakeholders has allowed more accurate estimates compared to those based on information from previous industry engagement, which underestimated several key costs via earlier assumptions.

On ii), cost profiles have changed significantly to reflect reduced frequency of required scenario analysis reporting. Trustees will now be required to undertake scenario analysis in the first year in which the regulations apply to them and (subject to checking annually whether the analysis should be refreshed) a maximum of every three years thereafter. It had been assumed previously that the analysis would be undertaken annually. Costs have been increased in the early years but lowered on an on-going basis, with an overall reduction in costs compared to the enactment stage IA.

On iii), costs have increased significantly since the enactment stage IA, mainly because schemes in scope now have to calculate three metrics rather than the two previously assumed.

In addition, the IA also used the consultation to improve its assessment of familiarisation costs. Compared to the enactment stage IA, the Department has increased familiarisation time from three to five hours. Costs are also higher due to an increased estimated number of trustees per scheme and a higher average hourly cost than initially assumed. Overall, the EANDCB for the measure has increased from £4.7 million to £6.2 million.

SaMBA

The IA includes a SaMBA (paragraphs 146-149). The phasing of the proposals, starting with large pensions schemes and moving on to medium-sized ones, is expected to limit the impact on smaller pension providers. The IA explains why master trusts (including those with less than £1bn total asset value) have been included in phase 1, drawing mainly upon level playing field arguments. The IA notes that the Government proposes to review implementation in 2023 and consult more widely again before potentially extending the requirements to schemes with less than £1bn in assets. The SaMBA could be improved by providing information on the size distribution of affected pension scheme providers and discussing any difficulties associated with applying the SaMBA employee thresholds to this proposal.

Rationale and options

The IA sets out existing requirements for trustees of pension schemes in respect of their fiduciary duty in relation to financially material factors such as climate change and other environmental, social and governance (ESG) factors. These include: from October 2019, trustees of defined contribution (DC) schemes will have to publish their policy in the scheme's Statement of Investment Principles (SIP); from October 2020 this will have to be accompanied by an implementation statement setting out how they have followed their ESG and climate change policies. Requirements have also been introduced for trustees of defined benefit (DB) schemes. The IA sets out evidence to suggest that some trustees have not yet made substantial changes to their governance, risk management and strategy processes in response. This includes the TPR DC schemes survey finding that only 21 per cent of schemes took climate change into account when formulating their investment strategies and approaches.

The IA discusses a non-regulatory option of providing 'guidance only' but explains why this was not taken forward (paragraphs 24-29). The IA sets out a reasonable case for further changes but would be improved by discussing further the evidence justifying the need to impose new measures now, given the very recent introduction of some existing measures. The IA could also be improved by considering the potential for sub-options of the proposed regulatory option, given that it appears to contain four fairly distinct core areas.

Cost-benefit analysis

<u>Evidence and data</u>

As noted above, the Department has used consultation to improve its evidence and refine its estimates of impacts on business. The Department has also usefully added monetised costs to the regulator (paragraphs 110-113).

The IA uplifts wage costs by 27 per cent to allow for overheads (page 33). The IA could be improved by addressing why this is more appropriate than applying the (slightly lower) non-wage labour cost adjustment approach set out in the RPC short guidance note on implementation costs.[3]

<u>Modelling</u>

The IA does not monetise benefits but provides two quantitative illustrations to accompany the qualitative description. First, it notes that for the exercise to be cost-neutral for the industry as a whole, the increased climate-related information feeding into trustee decision-making would need to improve industry-wide returns by 0.0005 percentage points (page 24). Second, the IA provides some illustrative estimates of annual transparency benefits to some scheme members, using a 'willingness to pay'

[3] https://www.gov.uk/government/publications/rpc-short-guidance-note-implementation-costs-august-2019

approach. These assessments are a useful addition to the analysis but highly speculative and the Department's decision not to include them in the NPV analysis appears to be appropriate.

Risk and uncertainty

The IA has helpfully addressed comments in the previous RPC opinion around risks of compliance with requirements being 'tick box' with little material change in investor behaviour and, conversely, risks to pension schemes providers and members of failing to deliver appropriate financial returns (paragraphs 118-125). The IA also usefully sets out key assumptions and provides a sensitivity analysis (including a summary table at the end of the IA).

The IA should clarify whether these requirements impact DB schemes and their sponsor firm's covenants, where that sponsor firm itself faces significant climate risks, in addition to the risks relating to the scheme's assets.

Wider impacts

The IA includes a section on 'wider economic and societal impacts', covering possible beneficial consequential environmental impacts and effects on investment decisions. The IA would be improved by explaining why the proposal is not expected significantly to affect trade, innovation or competition.

Monitoring and evaluation plan

The IA explains that the Government proposes a review in 2023 and that this would include examining the emerging effects of the measures and any unintended consequences. The IA also notes that the Government also proposes to consult more widely again in 2023 before extending the measures to schemes with less than £1bn in assets, taking account both of the quality of climate risk governance and associated disclosures carried out to date, and the current and future costs of compliance. The plan could be improved by describing the data that will be collected to review the measure will be collected and providing more details on how it will be used.

Other Comments

The IA could benefit from discussing briefly how the proposal relates to current proposals from the Department for Business, Energy and Industrial Strategy in relation to audit reform and mandating climate-related risk disclosures.

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For further information, please contact regulatoryenquiries@rpc.gov.uk. Follow us on Twitter @RPC_Gov_UK, LinkedIn or consult our website www.gov.uk/rpc.