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Sent by email to pensions.governance@dwp.gov.uk

12 March 2021

Dear all,

<u>Consultation response: Taking action on climate risk: improving governance and reporting by occupational pension schemes</u>

I am writing to respond to the Department of Work and Pensions' consultation, *Taking action on climate risk: improving governance and reporting by occupational pension schemes,* on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. Among other activities, we work with the financial services sector to promote integration of sustainability factors in investment decisions, long-term stewardship of assets and the consideration of the view of clients, beneficiaries and pension scheme members.
We welcome the important and ground-breaking step taken by the Department for Work and Pensions in developing a regulatory framework for mandatory TCFD reporting by pension schemes. Although we have made some further recommendations below, the framework is well considered, with an appropriate and helpful level of detail, and wholly proportionate to the nature and urgency of climate risks faced by pension schemes.

We note from the consultation documents that the DWP has explored the methodologies available for measuring the climate impacts of pension fund portfolios but concluded that more work is required before these can be implemented. We understand that the methodologies are not yet sufficiently well developed to justify consulting on introducing an implied temperature rise into the regulatory framework and we acknowledge that it is necessary to build a consensus on these methodologies to ensure transparency and accountability. However, the macroeconomic risks around climate change can only be addressed by a framework that addresses how far investment portfolios are Paris-aligned, and we call on the UK Government and the pensions industry to accelerate this work in line with the urgency and scale of the climate crisis.

While we were pleased to see the publication of a TCFD roadmap in November 2020, we recognise that most of these plans are only indicative at this stage. We would urge the UK Government to take a clear and joined-up approach to implementing TCFD, to ensure trustees receive the support they need in their reporting. In particular, given the important role asset managers have in relation to managing pension schemes' assets, we would be concerned if the FCA's implementation of TCFD is less ambitious than that of DWP.

Question 1

Scope and Timing

a) Do you have comments on the proposals to change the “reference date” used for the purposes of determining whether a scheme is in scope, or the arrangements made for schemes which obtain their audited accounts later than 1 October 2021, or 1 October 2022?

We agree with these proposals. They should ensure that all schemes have certainty about whether they will be in the scope of the first wave and ensure they have sufficient time to publish their TCFD report.

We also agree with the DWP that it is right not to postpone these duties or have a “rehearsal year” given the urgency of the climate crisis. We agree with the proposals that all schemes will have a publication deadline of 7 months from their respective scheme year end – we do not think there is value in schemes with later scheme year ends being required to rush out substandard TCFD reports.

b) Do you have comments on the draft regulations on scope and timing?

We broadly agree with the wording of the draft regulations on scope and timing. However, we would recommend that DWP includes a commitment in the regulations to undertake the 2023 review on extending the scope of the reporting requirements to smaller schemes. Given how long it has taken the pensions sector to start to embrace climate change as an important financial risk, we are sceptical that many of the smaller schemes will follow DWP’s suggestion that “smaller schemes not in scope…begin to report on a voluntary basis in the interim period, wherever it is proportionate to do so” (page 51). However, we would be happy to work with DWP on promoting best practice and encouraging schemes to go further.

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 2

Trustee knowledge and understanding

a) Do you have any comments on the draft regulations on trustee knowledge and understanding?

We broadly agree with the wording of the regulations on trustee knowledge and understanding. However, we would suggest that trustees excluded from reporting requirements under the regulations are still subject to requirements for climate-related trustee knowledge and understanding. While we understand that the Government plans to undertake a review in 2023 about extending the scope of the reporting requirements to smaller schemes, we feel that excluding trustees of smaller schemes from climate-related knowledge and understanding requirements in the meantime would send the wrong message to these trustees, and potentially disadvantage members of these smaller schemes.

We are not convinced that The Pensions Regulator (TPR) has sufficient internal supervisory expertise or capacity in respect of climate change. Therefore, whilst we note the possibility that TPR may issue improvement notices and civil penalties where trustees are not able to demonstrate knowledge and understanding, we think this is unlikely to happen in practice. Government should require The Pensions Regulator to invest in its supervision of trustees in respect of climate change and ESG factors.

b) Do you have any comments on the draft guidance?

We are broadly supportive of the wording on the guidance on trustee knowledge and understanding. However, we are concerned that the guidance on knowledge and understanding is not statutory guidance. We understand that the DWP does not currently have the power to make the guidance statutory but would encourage this to be altered in future if there is an opportunity to do so.

We would also suggest amending the wording on stewardship (paragraph 34) for the purpose of clarity. While we appreciate that this section of the guidance is concerned with trustee knowledge and understanding, we are concerned that the current wording may imply that the main purpose of stewardship for trustees is to improve their personal knowledge of climate change risk and opportunities. We would suggest amending the first part to read: “Stewardship activities, including engagement and voting activities, can promote the long-term success of pension schemes *by encouraging investee companies to take a long-term, responsible approach to their business strategy and ensure this is aligned with international climate goals. Moreover,* through engagement with intermediaries…”

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 3

Governance

a) Do you have any comments on the draft regulations on governance?

We agree with the wording of the draft regulations on governance.

b) Do you have any comments on the draft statutory guidance?

We are supportive of the wording of the draft statutory guidance on governance. We believe it addresses some important principal-agent issues in pension governance, especially relating to how responsibility is attributed and documented along the investment chain. However, we would recommend that the DWP liaises with the Solicitors Regulation Authority and Bar Standards Board to ensure that legal advisors have appropriate expertise and are meeting appropriate standards in relation to climate-related legal advice, given their exclusion under this sector.

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 4

Strategy

a) Do you have any comments on the draft regulations on strategy?

We agree with the wording of the draft regulations on strategy. We are pleased to see that the DWP has required trustees to state in their TCFD report precisely what time horizons they have chosen (i.e. how they have defined short, medium and long term). We are also supportive of the DWP not proposing to add an element of proportionality or “as far as they are able” (excluding scenario analysis) to its original proposals on strategy, on the basis that trustees should not need extensive data to plan strategically about climate risks and opportunities.

b) Do you have any comments on the draft statutory guidance?

We broadly agree with the wording of the draft guidance on strategy. However, we would strongly encourage the DWP to include wording that more specifically addresses the system-wide nature of climate risk and how it may impact on portfolios. We are concerned that trustees will take a narrow view of the assets to which climate change poses risks. However, some of the greatest risks lie outside the “obvious” sectors of fossil fuels and transport. Heavy industry, such as cement, steel and plastics, and sectors like real estate have extremely high carbon footprints. There are also nuances in relation to alternative energy sources. For example, trustees might not perceive the possible negative implications of climate change for the nuclear power sector: but if water is in short supply and there is not enough for cooling processes, this would pose serious risks to the functioning of nuclear power stations.

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 5

Scenario Analysis

a) Do you have any comments on the provisions on scenario analysis in the draft regulations?

We broadly agree with the wording of the draft regulations on scenario analysis. We are supportive of the requirement to conduct scenario analysis being on a three-year cycle, for the reasons given by respondents to the previous consultation, provided that trustees are still required to do an annual review and carry out new analysis where they consider this to be necessary – and there should be a high bar for not undertaking new analysis. We are supportive of the proposal in the regulations that trustees be required to explain why they have chosen not to do a new analysis, as this will provide an important incentive and indicator of whether or not their decision is justifiable. We would still encourage the DWP to create a regulatory requirement for schemes to undertake analysis in at least three scenarios, although we are pleased to see the guidance confirm that trustees should model scenarios consistent with an orderly transition, disorderly transition and no or limited transition.

b) Do you have any comments on the proposal that all assets of the scheme, including relevant contracts of insurance, are within scope for scenario analysis?

We agree that all assets of the scheme should be within the scope for scenario analysis. Without a requirement of this kind, it seems unlikely that there will be sufficient incentive for this data to be made available. Furthermore, the requirement to undertake scenario analysis “as far as they are able” gives trustees scope to exclude assets where they really cannot obtain data or where it really is too costly to do so. But they should not start from the assumption that certain asset classes are already excluded – there will be value in trustees thinking about each of the asset classes in turn. However, in order to avoid trustees overly relying on this “as far as they are able” provision, we would agree with respondents to the previous consultation that further guidance should be published by the Government (perhaps in collaboration with industry) on how to perform calculations for asset classes where less data is available.

c) Do you have any comments on the draft statutory guidance on scenario analysis?

We agree with the wording of the draft guidance on scenario analysis. We note that it allows trustees do qualitative analysis – this would therefore allow trustees to cover asset classes where the data is less available or reliable.

Please include in your answer any comments on whether you consider that they meet the policy intent started in this chapter.

Question 6

Risk Management

a) Do you have any comments on the draft regulations on risk management?

We broadly agree with the wording of the draft regulations on risk management. As in our answer to 4(b), we would strongly encourage the DWP to include wording that more specifically addresses the system-wide nature of climate risk and how it may impact on portfolios.

More generally, we support the increased attention given to stewardship in this section of the consultation document, following comments from respondents. Stewardship will play a key role in ensuring that carbon-intensive companies transform their business models in alignment with the low-carbon economy, thus mitigating significant climate-related risks for pension funds. However, weak climate-related resolutions and poor voting practices are still common among asset managers, and pension schemes struggle to get the information they need to oversee the use of their voting rights, as highlighted in a recent report by the Association of Member Nominated Trustees.[1] We would recommend that the Department for Business, Energy & Industrial Strategy and the DWP work in collaboration to create a mandatory disclosure framework with a clear definition of a 'significant' vote that is consistently applied by all asset managers, and monitored and enforced by a regulator. This would provide asset owners with better transparency and comparability around voting practices and help them to identify key resolutions on climate change. We have repeatedly argued that this could be done under powers in the Companies Act 2006 (s.1277 etc) and that there is an urgent need for these to be enacted for pension schemes regardless of whether or not they are needed for the other entities listed in s.1278.

b) Do you have any comments on the draft statutory guidance?

We broadly agree with the wording of the draft guidance on risk management. As in our answer to 4(b), we would strongly encourage the DWP to include wording that more specifically addresses the system-wide nature of climate risk and how it may impact on portfolios.

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 7

Metrics

a) Do you have any comments on the draft regulations on metrics?

We are supportive of the wording of the draft regulations on metrics.

b) Do you have any comments on the draft statutory guidance?

We are broadly supportive of the wording of the draft guidance on metrics. We would suggest including wording that emphasises the importance of including data on scope 3 emissions as far as possible, as well as the challenge trustees may face in obtaining it. Since the proposed list of non-emission based metrics covers a range of very different kinds of measures, we would suggest requiring trustees either to select more than one non-emission based metric, or to include an explanation of why they have chosen the metric in question (why they had chosen to measure 'data quality', for example, over 'portfolio alignment') and why this particular metric will help in their overall risk management. Our concern is that trustees will just opt for the "easiest" metric regardless of whether or not it helps them to manage climate risk better.

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[1] https://amnt.org/wp-content/uploads/2020/11/AMNT-report-on-obstacles-to-trustee-voting-3-Nov-2020.pdf

We would suggest offering further guidance for trustees on the advantages and disadvantages of calculating carbon footprint in relation to the whole portfolio or only part. Calculating the carbon footprint for only part of the portfolio may risk failing to consider the emissions associated with a particular carbon-intensive sector. At the same time, calculating a carbon footprint for the entire portfolio may mean that emissions calculations appear to fall purely because the scheme increases its holdings in less carbon-intensive companies without actually reducing its carbon-intensive holdings (and thus its exposure).

We would suggest that emissions of scheme assets are calculated in line with scope 3 category 15 of the GHG Protocol Methodology including both required and optional accounting items where applicable, in particular debt investments without known use of proceeds. This is to ensure that debt issuances by companies operating in high-carbon sectors but not tied to a specific high-carbon asset are captured in the metrics.

We note also that the guidance states that, for listed and unlisted equities and for corporate bonds, the Enterprise Value Including Cash (EVIC) may be used as a measure of the total equity and debt. However, this is not applicable to unlisted equities as it is a market-based metric.

We strongly support the requirements to obtain scope 1, 2 and 3 emissions, as it is clearly necessary for end-consumer use of high-carbon products to be incorporated into trustees' analysis.

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 8

Targets

a) Do you have any comments on the draft regulations on targets?

We are broadly supportive of the wording of the draft regulations on targets. We agree that the original proposal for trustees to set new targets every year should be replaced by a requirement to review each year whether to replace or maintain the target.

b) Do you have any comments on the draft statutory guidance?

We are supportive of the wording of the draft regulations on targets.

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 9

Disclosure

a) Do you have any comments on the draft regulations on disclosure?

We agree with the wording of the draft regulations on disclosure.

b) Do you have any comments on the draft statutory guidance?

We agree with the wording of the draft guidance on disclosure.

Please include in your answer any comments on whether you consider that they meet the policy intent stated in this chapter.

Question 10

Penalties

Do you have any comments on the draft regulations on penalties?

We believe it is sensible for The Pensions Regulator to be required to issue a mandatory penalty where no report is published, and have the discretion to issue a penalty where they consider the report to be inadequate.

We believe that it is proportionate to allow trustees to perform some analysis for their reports under the "as far as they are able" qualification, given TCFD reporting is not yet mandatory across the investment system. However, we are concerned that this will result in such a range of responses that TPR will need to ensure it has proper expertise and time available to do a proper review of reports. We would recommend that the DWP and TPR publish a plan to look at the quality of reports, with a commitment to work with schemes to improve their reports rather than go straight to penalty.

Please include in your answer any comments you have on whether you consider that they meet the policy intent stated in this chapter.

Question 11

Impacts

In relation to the policy changes we have made, do you have any comments on the regulatory burdens to business and benefits, and wider non-monetised impacts which are estimated and discussed in the draft impact assessment?

We believe that any burden on business is immeasurably outweighed by the burden that would befall it, together with communities and the environment, if the climate crisis goes unchecked.

Question 12

Any other comments

Do you have any other comments you would like to raise?

No further comments.

Yours sincerely,

Rachel Haworth

Policy Manager, ShareAction