Sackers

Government response to consultation on climate change regulations and guidance

Introduction

On 8 June 2021, the DWP published its response to the January 2021 consultation, "Taking action on climate risk: improving governance and reporting by Occupational Pension Schemes" (see our Alert), together with revised draft regulations and draft statutory guidance ("the Regulations" and "the Guidance", respectively).

Key points

- The Regulations are largely unchanged following consultation, with the Guidance revised "to provide further clarity and support for trustees when complying with the requirements".
- From 1 October 2021, trustees will be required to meet climate change governance requirements which underpin the Taskforce on Climate-related Financial Disclosures ("TCFD") recommendations and to produce and publish (on a publicly available website, accessible free of charge) a report on how they have done so ("the Report").
- The requirements will be phased in. Broadly, trustees of occupational pension schemes whose net assets (excluding bulk and individual annuity contracts) ("relevant assets") are £5bn or more at the end of their first scheme year to end on or after 1 March 2020, authorised master trusts and authorised collective money purchase schemes must comply from 1 October 2021 and produce their Report within 7 months of their scheme year end date. Schemes with £1 billion or more of assets will be in scope from the following year.
- Members will have to be informed via the annual benefit statement (DC schemes) or the annual funding statement (DB schemes) that the Report has been published and where they can locate it.
- To ensure that trustees will be able to understand the outputs of activities such as scenario analysis and calculating emissions-based metrics, and to incorporate them into their new climate change risk management processes, trustees of schemes which are in scope must have the appropriate degree of knowledge and understanding.

Background

In 2017, the TCFD published 11 recommendations for all organisations, aimed at identifying, assessing, managing and disclosing climate-related financial risks and opportunities. In addition, the Government's Green Finance Strategy was published in July 2019 setting out a range of actions in relation to the environment and climate change. Amongst the announcements was the Government's expectation for all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022. Furthermore, in November 2020, the UK joint regulator and government TCFD Taskforce: Interim Report and Roadmap announced its intention to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant proportion of mandatory requirements in place by 2023.

In January 2021, the Pensions Climate Risk Industry Group published final guidance on applying the TCFD recommendations to a pension scheme (for further detail see our ESG guide).

TCFD recommendations

The Regulations will require trustees to satisfy the 11 recommendations of the TCFD, and to report on how they have done so. When meeting certain of the requirements, trustees must have regard to the Guidance, with any deviations explained in the Report. Otherwise, the Guidance is intended to assist schemes, both in and out of scope of the Regulations, with carrying out climate change risk governance and reporting.

The Regulations will require trustees to:

- **Governance** - establish and maintain, on an ongoing basis, oversight of the climate-related risks and opportunities which are relevant to the scheme. They must also establish and maintain processes for the purpose of satisfying themselves that persons undertaking governance on their behalf, are taking adequate steps to identify, assess and manage climate-related risks and opportunities which are relevant to the governance activities they are undertaking and that persons who advise or assist the trustees with respect to governance are taking adequate steps to identify and assess climate-related risks and opportunities which are relevant to the matters they are advising or assisting on.

- **Strategy** - identify and assess, on an ongoing basis, the impact of climate-related risks and opportunities which they consider will have an effect over the short term, medium term and long term on the scheme's investment strategy and (where it has one) the scheme's funding strategy.

- **Scenario analysis** - as far as they are able, undertake scenario analysis assessing the impact on the scheme's assets and liabilities, the resilience of the scheme's investment strategy and (where it has one) the scheme's funding strategy for at least two scenarios – one of which corresponds to a global average temperature rise of between 1.5 and 2°C inclusive on pre-industrial levels. This analysis must be carried out in the first year in which the requirements apply to a scheme and at least every three years thereafter. In a slight change to the proposed policy, whenever trustees undertake fresh scenario analysis, the triennial cycle is automatically reset to three scheme years thereafter. It is also now clear that where trustees become subject to requirements part way through a scheme year, they may rely on scenario analysis undertaken earlier in that scheme year, provided it otherwise meets the requirements of the Regulations. Where a scheme has both DB and DC sections, separate scenario analysis will be required for both the DB section(s) and the DC default fund(s). Should the trustees have not been able to undertake scenario analysis in relation to certain assets, they must explain why this is the case in their Report.

- **Risk management** - establish and maintain, on an ongoing basis, processes for identifying, assessing and effectively managing climate-related risks which are relevant to the scheme and integrating them into the trustees' overall risk management.

- **Metrics** - select and, in each scheme year, as far as they are able, calculate an absolute emissions metric and one emissions intensity metric and one additional climate change metric. The Guidance and Regulations have been amended to state that trustees should use total emissions and carbon footprint metrics – calculating Scope 1 and 2 greenhouse gas emissions in the first scheme year they are subject to the requirements, and then Scope 1, 2 and 3 in all subsequent years. Trustees will be required, as far as they are able, to obtain the data required to calculate their chosen metrics on an annual basis and their selection must be reviewed from time to time, as appropriate to the scheme. Where metrics are dropped following review, replacement metrics must be selected.

- **Targets** - set a non-binding target for the scheme in relation to at least one of their chosen metrics and, as far as they are able, measure performance against it in each scheme year (rather than annually). The DWP has now made clear that performance against the target is the only criterion which trustees must consider when determining whether to retain or replace that target.

- **TKU** - have an appropriate degree of knowledge and understanding of how to identify, assess and manage risks to occupational pension schemes arising from the effects of climate change and the opportunities relating to climate change. The DWP has amended the Regulations to align with the language around risks as well as reflect the intention that trustees should have an appropriate and equal degree of knowledge and understanding to identify, assess and manage both risks and opportunities.

"As far as they are able" is defined as trustees taking all such steps as are reasonable and proportionate in the particular circumstances taking into account the costs, or likely costs, which will be incurred by the scheme and the time required to be spent by the trustees or any people acting on their behalf. Examples are set out in the Guidance.

Timing

The Regulations will be phased in, with larger schemes being the first to comply. As noted above, they carve out bulk and individual annuity contracts (relevant contracts of insurance) for the purposes of determining the asset threshold of a scheme. Following consultation, the DWP has refined the definition of a relevant contract of insurance with the aim of making clear that, in the case of bulk-annuity contracts, it does not require:

- an exact matching of the level of benefits specified in the contract and those payable under the scheme rules

- the intention to meet costs in all circumstances (only irrespective of future financial market conditions or scheme member longevity), or

- the insurer to have unfettered discretion in relation to the investment policy of the assets used to meet its liabilities under the contract.

The DWP has also clarified that where trustees are subject to the requirements for part of a scheme year, their report need only cover that part scheme year.

Trustees of schemes with relevant assets ≥ £5bn at the end of their first scheme year to fall on or after 1 March 2020:

- must meet the climate change governance requirements for the current scheme year from 1 October 2021 to the end of that scheme year, and

- must publish a TCFD report on a publicly available website within 7 months of the end of that scheme year, and a link must be included in the Annual Report and Accounts for that scheme. (The ultimate deadline of 31 December 2022 which was proposed in the August 2020 consultation has been removed.)

For schemes with relevant assets ≥ £1bn the above requirements apply one year later.

Schemes cease to be subject to the climate governance requirements with immediate effect when they are no longer authorised and / or have assets of less than £500 million. However, they must still publish their Report for the scheme year which has just ended in the usual timescale. Only non-authorised schemes with zero relevant assets at scheme year end will be excluded from reporting.

Trustees will be required to provide TPR, via the scheme return, with the website address(es) for their most recent Report, their SIP, implementation statement and relevant excerpts of the Chair's statement (as applicable).

The FCA plans to consult on TCFD-aligned rules for asset managers and for workplace personal pension schemes imminently. Subject to that consultation, it is proposed that final rules will be published by the end of 2021 and come into force in early 2022. "This will increase the flow of data that is vital to trustees to embed effective climate risk governance."

Penalties

TPR will have discretion to administer a penalty for a Report it deems to be inadequate in meeting the requirements, but a mandatory penalty (of at least £2,500) applies where TPR is of the opinion that a person has failed to publish a Report on a publicly available website, accessible free of charge.

Failure to notify members of the Report's availability, or to include a link to the Report in the scheme's annual report will be subject to the existing penalty regime on disclosure of information (civil penalties of up to £5,000 for an individual and up to £50,000 in any other case).

Next steps

The Regulations are due to come into force on 1 October 2021. The DWP intends to review the requirements in the second half of 2023.

Schemes likely to fall within the first wave (compliance from 1 October 2021) should have started the necessary preparations, and those likely to be in the second (compliance from 1 October 2022) should not be far behind. Bearing in mind trustees' fiduciary duty to be actively considering climate change as a likely financially material risk, those comfortably outside of scope (for the time being) should consider whether to voluntarily adopt some or all of the requirements.

If you have any questions on any of the above, please speak to your usual Sackers contact.

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