Written evidence from the Department for Work and Pensions (PSC0022)

Q1. How should pension schemes contribute to setting COP26 targets and helping to achieve the targets once agreed?

All pension schemes should manage climate risk, and target setting is a good way of doing so, but Government also needs to act and is doing so.

Under our draft Regulations laid before Parliament in June, larger schemes and authorised multi-employer schemes ('master trusts') will be required to set climate-related targets from October 2021,[1] ahead of COP26, but they are free to set those most appropriate for their scheme. Many schemes have voluntarily signed up to net zero targets – we welcome that. But imposing mandatory net zero targets cuts across trustees' fiduciary duties and could drive divestment over engagement.

Trustees can use two main strategies to achieve climate targets – asset allocation (the types of assets they invest in) and stewardship (how they oversee the investments they hold – through engagement and voting). More on these strategies can be found at paragraph 21 onward.

1. Our answer interprets COP26 targets as targets set by occupational pension schemes in relation to climate change, in the run up to, during or soon after COP26.

Trustees' fiduciary and statutory duties

2. Trustees have a fiduciary duty to act in the best interests of pension scheme beneficiaries.[2] This involves duties to act prudently, conscientiously and in good faith, seeking advice where needed.
3. In 2014, the Law Commission clarified the legal concept of fiduciary duties as applied to investment. It confirmed that trustees should take into account factors which are financially material to the performance of an investment, whatever their source.[3]
4. Given the nature and likely materiality of the financial risks posed by climate change,[4] trustees' fiduciary duties require them to take it into account. In line with the prudent person principle, trustees must consider likely future climate scenarios, how these may

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[1] The draft Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 - https://www.legislation.gov.uk/ukdsi/2021/9780348224382/data.pdf.

[2] There is also a statutory duty on many schemes for pension scheme assets to be invested in the best interests of members and beneficiaries. See the Occupational Pension Schemes (Investment) Regulations 2005 (S.I. 2005/3378), regulation 4(2)(a).

[3] Law Commission, Fiduciary Duties of Investment Intermediaries (LC350) – July 2014 – https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/

[4] Climate change affects the financial system through two main channels: physical risks and transition risks. DWP's August 2020 consultation explains these risks in more detail. https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes/chapter-1-background-and-summary-of-proposals, see "Figure 1" and paragraphs 7-8.

impact their investments and what a prudent course of action might be as part of their scheme's risk management framework.

5. As of 2019, trustees of occupational pension schemes with 100 or more members have been required to set out in their statement of investment principles (SIP) policies on stewardship and on environmental, social and governance considerations (ESG), including climate change, that they consider financially material. Trustees of Defined Contribution (DC) and hybrid schemes have been required to publish their SIPs since 1 October 2019, and trustees of Defined Benefit (DB) schemes have been required to publish their SIPs since 1 October 2020.[5]

Putting the recommendations of The Task Force on Climate-related Financial Disclosures (TCFD) into law

6. The UK will be the first economy to mandate TCFD reporting for its pensions sector. In the 2019 Green Finance Strategy, the government established a Taskforce, chaired by HMT and made up of regulators and government departments, to explore the most effective approach to implementing the recommendations of the TCFD. The UK Taskforce's Interim Report, and accompanying roadmap, sets out an indicative pathway for the UK to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements in place by 2023. [6] DWP's draft Regulations, which mandate TCFD reporting for occupational pension schemes, mark a significant contribution to the UK Government's efforts towards mandatory TCFD-aligned disclosures by 2025.
7. The TCFD was established by the Financial Stability Board during the Chairmanship of Mark Carney in 2015. In June 2017, the TCFD published 11 climate-related financial disclosure recommendations including 1 pillar related to Metrics and Targets.[7] The recommendations were designed to be adoptable by all organisations across both the real economy and the financial sector, including occupational pension schemes.
8. DWP's draft Regulations[8], which are before Parliament, and if approved are due to come into force on 1 October 2021, will require occupational pension scheme trustees to undertake governance activities relating to each TCFD recommendation, and report annually on those activities. The Regulations will initially apply to larger schemes[9] and to all authorised master trusts as well as schemes authorised to provide collective money

[5] See the amendments made to regulation 29A of the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 (S.I. 2013/2734) by regulation 5 of the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 – (S.I. 2018/988) and by regulation 3 of the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019 (S.I. 2019/982).

[6] UK joint regulator and government TCFD Taskforce: Interim Report and Roadmap - Published 9 Nov 2020.

[7] https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf

[8] https://www.legislation.gov.uk/ukdsi/2021/9780348224382/data.pdf

[9] Schemes with £5bn+ in assets from 1 October 2021 and £1bn+ from 1 October 2022. On current figures, around 100 of the largest occupational schemes, accounting for 40% of assets (£750bn) and 70% of members, will be in scope from October 2021. Again on current figures, 350 large schemes, accounting for 70% of assets (£1.3tn) and 80% of members will be in scope from October 2022.

purchase benefits (also known as collective defined contribution schemes), once established.

Mandatory metrics and targets

9. Under the 'Metrics and Targets' section of the Schedule to DWP's draft Regulations, trustees will be required to calculate the greenhouse gas emissions of their investment portfolio[10]. They will be required to select and report on a minimum of one absolute emissions metric,[11] one emissions intensity metric[12] and one additional climate change metric,[13] and must review their metric selections from time to time as appropriate to the scheme.

10. Trustees will also have to set a target for the scheme in relation to one of the metrics they have selected to calculate. In each scheme year they will be required to measure performance against the target[14] and, taking into account that performance, determine whether it should be retained or replaced. There is no requirement that the scheme must meet the target set, but trustees will have to report their metrics and performance against their target in their published TCFD Report for that scheme year. Statutory Guidance, published in draft alongside the draft Regulations, offers more detail.

11. Consistent with the Law Commission's conclusions, the target is purely for the management of material climate-related risks and opportunities – trustees are not expected to align their own targets with other schemes or Government's targets (e.g., net zero). It is up to trustees to decide, in line with their fiduciary duty, which targets to set.

Pension schemes and net zero targets

12. Governments around the world, including the UK, have signed up to the Paris Agreement,[15] with the aim of holding the global temperature increase to well below 2 degrees Celsius and pursuing efforts to limit the temperature increase to 1.5 degrees Celsius, above pre-industrial levels. To meet the 1.5 degrees global warming goal in the Paris Agreement, global carbon emissions need to reach net zero in 2050[16].

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[10] To recognise that trustees will, at least initially, encounter difficulties obtaining underlying data to calculate metrics for all of the assets of the scheme, they will be required to calculate their selected metrics "as far as they are able". This is defined in paragraph 25 of the Schedule to the draft Regulations to mean that trustees are required to take 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 by persons to whom they have delegated responsibility.

[11] The Statutory Guidance issued in draft alongside the draft Regulations state that trustees should use Total GHG emissions for their absolute emissions metric.

[12] Under the Statutory Guidance trustees will be expected to use Carbon Footprint as their emissions intensity metric.

[13] Under the Statutory Guidance trustees will be expected to select a portfolio alignment metric, climate value at risk metric or data quality metric. With this, and other metrics, trustees will be able to select an alternative metric, but will be expected to explain why.

[14] The requirement to measure performance against their target will also apply to the trustees "as far as they are able".

[15] https://unfccc.int/files/meetings/paris_nov_2015/application/pdf/paris_agreement_english_.pdf

[16] https://www.ipcc.ch/2018/10/08/summary-for-policymakers-of-ipcc-special-report-on-global-warming-of-1-5c-approved-by-governments/

Voluntary net zero targets

13. We applaud the many pension schemes who have set net zero targets for the greenhouse gas emissions of their own portfolio. Voluntary net zero targets can be extremely helpful and we expect schemes will want to be seen to set ambitious targets which are still compliant with their fiduciary duty.

14. Setting voluntary targets gives schemes the opportunity to manage the risks to pension scheme beneficiaries associated with the transition to a low carbon economy, whilst also driving decarbonisation in the wider economy.

15. In March 2021, Corporate Adviser reported that 10 out of 17 leading DC providers[17] had made commitments to net zero by 2050 or before. Since publication of that report, yet more schemes or their sponsors have done so. Of the providers featured in the Corporate Adviser report, we understand that only three have yet to commit[18].

16. The UK's two largest DB pension schemes, the Universities Superannuation Scheme[19] and the BT Pension Scheme[20], have also set net zero targets.

17. Furthermore, several schemes are also voluntarily signed up to the 'Net Zero Investment Framework',[21] launched by the Institutional Investors Group on Climate Change (IIGCC) in March 2021. The Framework is designed to provide a basis on which a broad range of investors can make commitments to achieving net zero emissions and define strategies, monitor progress, and transition portfolios.[22] Several other pension schemes have signed up to the Net Zero Asset Owners Alliance[23] which requires similar net zero commitments.

Mandatory net zero targets

18. It may not always be in the best interests of pension scheme beneficiaries for trustees to be required to set net zero targets, however well-meaning or ambitious those targets might be. For example, there could be times where a net zero target might be detrimental to risk adjusted return. If trustees were mandated to make investment decisions with the sole goal of achieving net zero in mind, it could have negative outcomes for members.

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[17] Corporate Adviser Intelligence, ESG in DC Pensions Report, February 2021. https://corporate-adviser.com/dc-providers-net-zero-targets-revealed-concept-enters-mainstream/

[18] Corporate Adviser report that Evolve are in the process of developing such a target. One other large master trust not featured in the report, Now:Pensions, has also not committed to net zero.

[19] https://www.uss.co.uk/news-and-views/latest-news/2021/04/05042021_uss-announces-net-zero-ambition

[20] https://www.btpensions.net/news/bt-pension-scheme-sets-2035-net-zero-goal-for-its-entire-55bn-portfolio

[21] https://www.parisalignedinvestment.org/media/2021/03/PAII-Net-Zero-Investment-Framework_Implementation-Guide.pdf

[22] The list of UK pension schemes and pension providers already known to be drawing on the Framework is: Avon Pension Fund, Brunel Pension Partnership, BT Pension Scheme, Church of England Pensions Board, Cornwall Pension Fund, Devon County Council Pension Fund, Environment Agency Pension Fund, Lloyds Banking Group Pensions Trustees Limited, National Grid UK Pension Scheme, National Trust, Nest, Northern LGPS (the collective asset pool for the Greater Manchester, Merseyside and West Yorkshire local government pension scheme funds), Oxfordshire County Council Pension Fund, Royal London, Scottish Widows, South Yorkshire Pensions Authority, The Pensions Trust and Wiltshire Pension Fund.

[23] https://www.unepfi.org/net-zero-alliance/

19. In addition, mandatory net zero could force trustees to divest from investments rather than remain invested in a high emitting firm. If trustees divest, they cannot engage with those companies and steward them towards lower-carbon business practices. Evidence[24] suggests that the impact of engagement on a company's behaviour is more effective than selling out of assets.
20. DWP has **not** mandated trustees to set net zero targets. To do so could put trustees in a difficult legal position where they are at risk of breaching their fiduciary duties, particularly if the net zero target is contrary to the scheme beneficiaries' best interests. There is also a significant risk that such mandatory targets would trigger divestment from higher carbon firms which are in the process of transitioning to Net Zero. Pension savers would continue to experience the impacts of polluting firms, whilst their trustees would be unable to hold them to account.

Achieving targets

21. There are two broad approaches schemes are taking to help achieve targets, including net zero targets, for the emissions of their portfolio. The first involves **asset allocation**. This is achieved by:
    (1) *Active ESG/climate change integration* – many active fund managers report integrating climate change or wider environmental, social or governance considerations into investment decisions.
    (2) *Filtering or screening individual stocks or sectors* – individual stocks, or whole sectors/industries, are excluded from a fund or portfolio based on climate change factors.
    (3) *Tilting* – allocation to particular sectors or industries are either increased or decreased on climate change grounds.
    (4) *Climate opportunities* – investment in low carbon or resilient infrastructure, and 'best in class' approaches to stock selection, based on climate change factors.

22. However, except for new capital allocation to transition-friendly activities that might not otherwise have received funding, there is a question mark over the extent to which these strategies necessarily contribute towards net zero goals. Whilst tilting towards or away from certain stocks, will at the margin lower or raise the cost of capital, some argue that such strategies lead only to a change in asset ownership rather than real economy change.
23. The second approach is **stewardship**.[25] Stewardship by occupational pension schemes principally involves engagement with investee firms, either directly, or indirectly via asset managers, and voting at company AGMs. It can also be implemented through other

[24] Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact
Kölbel, Julian F., Florian Heeb, Falko Paetzold, and Timo Busch.
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3289544

[25] Defined by the Principles of Responsible Investment (PRI) as, "the use of influence by institutional investors to maximise overall long-term value including the value of common economic, social and environmental assets, on which returns and clients' and beneficiaries' interests depend".
https://www.unpri.org/stewardship/about-stewardship/6268.article

tools including engagement with policymakers and other standard setters. Engagement and voting on investee companies with poor records on addressing their risks from climate change should encourage them to improve their standards. If engagement proves futile, the pension scheme may think about divesting from that company.

24. We return to pension scheme and asset manager stewardship in Q3.

Q2. What role should international standards have in supporting pension schemes to assess climate change risks when considering scheme investments?

Internationally agreed standards and metrics are key to supporting pension schemes to assess climate change risks given the international scope of scheme investments. The TCFD's recommendations are a key example of this.

However, we cannot wait for fully-finalised international standards to emerge. DWP's own TCFD requirements on scenario analysis and metrics have been designed with emerging metrics in mind, and we continue to closely monitor emerging standards and will update our own guidance where necessary.

Domestic legislative requirements on assessment of climate change risks

25. As indicated above, the draft Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021, now before Parliament, set out a comprehensive framework requiring trustees to manage and report on climate change risk in accordance with the recommendations of the TCFD.

26. Several disclosures recommended by the TCFD and required in our Regulations need no reference to international standards. These include governance (trustees' oversight of climate-related risks and opportunities, and processes to satisfy themselves that others undertaking governance activities, or advising or assisting on governance activities, are taking steps on climate risk and opportunities), and risk management (processes for identifying, assessing and managing climate risk and integrating this into their overall risk management).

27. The Regulations will also require trustees to select and report on metrics (see Q1), and to carry out strategy-related activities including scenario analysis which considers how the scheme would fare in different temperature pathways. These requirements are more reliant on international standards to achieve comparable reporting.

Existing and developing standards

28. In setting out the requirements around metrics and scenario analysis, we have been careful to take account of existing and developing international standards.

<u>Metrics</u>

29. With regards to metrics, the GHG Protocol (greenhouse gas) establishes comprehensive global standardised frameworks for the measurement and management of GHG emissions from "real economy" organisations, including from the corporate value chain. The Partnership for Carbon Accounting Financials (PCAF) standard builds

on the GHG Protocol and identifies methodologies by which those emissions are attributable to investors including occupational pension schemes.

30. DWP's Statutory Guidance for disclosure of metrics and targets by occupational pension schemes has adopted the GHG Protocol and PCAF standards in a simplified way, providing indicative methodologies for asset classes such as sovereign bonds, derivatives and insurance contracts which the PCAF standard does not yet cover.

31. In this way, DWP has adopted international frameworks for the purposes of the calculation and use of climate metrics, whilst also setting out coherent but permissive standards where international standards do not yet exist. This allows continued broad comparability between pension schemes' climate risk reporting whilst allowing room for international standards to emerge.

Scenario analysis

32. In the case of scenario analysis, there are standard scenarios in existence, notably those developed by the Network for Greening the Financial System (NGFS)[26]. Each scenario seeks to take into account both physical and transitional risk. Three representative scenarios are explored:

- orderly: early, ambitious action to a net zero CO2 emissions economy;
- disorderly: action that is late, disruptive, sudden and / or unanticipated;
- hot house world: limited action leads to a hot house world with significant global warming and, as a result, strongly increased exposure to physical risks.

33. This approach is also followed in DWP's Statutory Guidance, which sets expectations of the scenarios trustees should consider, although trustees are only required to choose two scenarios to take account of the limited lifespan of many DB occupational schemes, and in recognition that any model may not work in every specific scheme circumstance.

34. We will continue to monitor the progress of the NGFS framework and will make changes where necessary to ensure continued alignment. More generally, we will look to update the Statutory Guidance to reflect wider developments in practice as well as international standards, following a review of the Regulations and Statutory Guidance in 2023.

The need for a permissive framework

35. One theme that is common throughout the work on domestic and international standards is an acknowledgement that all standards should strike the right balance between principles and prescription. Principles allow for flexibility as the state of knowledge and market practice evolves – which is especially important in an evolving space such as climate change – while a level of prescription is necessary to promote consistency and comparability in reporting.

36. This is particularly well illustrated in the case of scenario analysis. The TCFD itself has made clear that " scenarios are not intended to represent a full description of the future but rather to highlight central elements of a possible future…not forecasts, predictions or sensitivity analyses."[27] Pension scheme trustees should not seek solely to optimise

[26] https://www.ngfs.net/en/publications/ngfs-climate-scenario
[27] https://www.tcfdhub.org/scenario-analysis/

portfolios for a single purely illustrative scenario, or rigidly follow a rubric based on narrowly defined standards which do not allow for scheme-specific analysis.

37. We welcome the work to date on international standards, building on the TCFD recommendations. The UK has signalled its strong support for the work of the International Financial Reporting Standards (IFRS) Foundation in a joint statement in November 2020[28], and we will continue to monitor progress to agree a global baseline of standards for sustainability disclosures.

38. Emerging standards have been adopted in DWP's Statutory Guidance, which sets expectations of trustees whilst remaining flexible by allowing room for standards to evolve. In this way international standards will build on a solid foundation of emerging best practice. There would be no benefit – and much harm – in delaying trustee obligations to manage and report on climate risk.

Q3. Are there suitable financial products to enable pension funds to make climate-conscious investments? How should such investment be facilitated and supported?

We are not aware of a shortage of suitable financial products. However, continued failings in company-level disclosures remain a challenge.

Stewardship can be a key component of climate-conscious investments, yet research points to problems of under-investment by some asset managers and a lack of robust voting policies around climate change.

39. As set out in our answer to Q1, Government does not dictate how pension schemes invest. Trustees of occupational pension schemes are independent of Government – the schemes are private trusts, not public bodies. They are not bound by the commitments which Government has signed up to in domestic legislation such as the Climate Change Act 2008 or international agreements to which the UK is a signatory, such as the Paris Agreement. Trustees have primacy in investment decisions and are free to manage climate risk in the way that they, in line with their fiduciary duty, see fit. Government expects all investments made by pension scheme trustees to be climate-conscious.

Availability of products

40. Occupational pension schemes have therefore taken a variety of approaches to managing climate risk to their beneficiaries, using a wide variety of products. Many fund managers offering 'active' investment strategies report integrating consideration of climate risks into their stock selection and monitoring. Other approaches, and example products, include.

    - Tilted 'passive' investment strategies– for example via TPT's investment in LGIM's Low Carbon Transition Index Equity Fund which aims to reduce initial carbon emissions by 70% compared to the broad market capitalisation benchmark.[29]

[28] https://www.gov.uk/government/publications/joint-statement-of-support-for-ifrs-foundation-consultation-on-sustainability-reporting/initial-response-to-ifrs-foundation-trustees-consultation

[29] LGIM launches Low Carbon Transition Fund Range : Legal & General (legalandgeneralgroup.com)

- Renewable infrastructure – for example, via Nest's recent appointment of Octopus Renewables to invest £250m this year in renewables in the UK and Europe[30].
- Stewardship - for example, via AMX's offering in partnership with DWS[31], which allows trustees to set a more or less interventionist voting policy on climate issues.

41. We are therefore not aware of a shortage of suitable products, although trustees do report challenges distinguishing products which most effectively meet their needs. A challenge in determining the suitability of products is the ongoing lack of climate-related disclosures currently being made by companies. This is why the UK Government and financial regulators have announced their intentions to make climate risk reporting mandatory across the whole economy, including reporting of greenhouse gas emissions[32]. Additionally, for financial firms, including occupational pension schemes, scenario analysis – to assess how given funds would fare in different future temperature rises – will also be made mandatory.

A UK taxonomy

42. The UK Government has also committed to the development of a green taxonomy[33], a classification system with accompanying end-to-end disclosure which will give pension scheme trustees, and ultimately beneficiaries, quantitative information on the proportion of their portfolio invested in environmentally sustainable activities. Government expects to make announcements on the next steps around sustainability reporting in due course.

Paris-alignment reporting

43. However, the nature of a taxonomy means that it can only be a snapshot of the current sustainability of a pension scheme's investments. Whilst the taxonomy identifies how sustainable investments are right now, forward looking metrics use a combination of current data, short term investment plans and both short- and longer-term emissions targets to identify how sustainable an investment will be.

44. As set out in our August 2020 consultation[34], DWP is following closely the work of the Portfolio Alignment Team established by Mark Carney, UN Special Envoy for Climate and Finance, on approaches to forward-looking measurements of alignment with the Paris Agreement. A consensus on the required characteristics of such a measure is forming[35], and DWP will continue to give serious consideration to bringing forward proposals on Paris alignment reporting.

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[30] Nest joins us on the journey to a brighter future | Institutional Investors (octopusgroup.com)
[31] AMX and DWS develop new pooled funds service that allows pension schemes to express stewardship preferences
[32] UK joint regulator and government TCFD Taskforce: Interim Report and Roadmap - GOV.UK (www.gov.uk)
[33] Chancellor sets out ambition for future of UK financial services - GOV.UK (www.gov.uk)
[34] https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes
[35] Measuring Portfolio Alignment Assessing the position of companies and portfolios on the path to net zero https://www.tcfdhub.org/wp-content/uploads/2020/10/PAT-Report-20201109-Final.pdf

Role of stewardship

45. Finally, as noted in our answer to Q1, stewardship – the voting of shares, and engagement with both investee firms and investment managers – is another approach to managing climate risk. Stewardship can have a significant impact on the investee companies' - indeed, evidence[36] suggests that the impact of engagement on a company's behaviour is more effective than selling out of assets.

46. We do have concern over the quality of products in relation to stewardship – both in relation to the quality of stewardship policies, which trustees will rely on when making investment decisions – and in relation to the quality of voting and engagement reporting, which trustees will need in order to effectively monitor manager performance.

47. Whilst research shows some fund managers consistently vote in favour of climate-related resolutions[37], 2019 research carried out by the Association of Member Nominated-Trustees identified[38] that many fund management firms had voting policies on climate change which were vague or – for 53% of firms – non-existent. Research by Willis Towers Watson also highlights continued underinvestment by some large fund managers[39]. Vague or non-existent policies impede trustees' ability to ensure that companies' transition plans and net zero strategies are robustly challenged by their appointed investment managers, in the interests of the trustees' beneficiaries.

48. Many pension schemes also report difficulty obtaining fund-level data[40] on how their own holdings were voted by asset managers (rather than firm-level data where voting data on trustees' own holdings are mingled with records of stocks which they do not own.) This represents a barrier to effective monitoring.

49. DWP is therefore considering action to increase trustee focus on voting and engagement with a view to driving up the performance of asset manager stewardship. With that in mind, we have set up a Taskforce on Pension Scheme Voting Implementation (TPSVI) which will make recommendations to Government and regulators on measures to drive better voting policies and vote reporting, thereby improving overall stewardship outcomes[41].

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[36] Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact
Kölbel, Julian F., Florian Heeb, Falko Paetzold, and Timo Busch.
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3289544

[37] Voting Matters 2020: are asset managers using their proxy votes
for action on climate and social issues? https://shareaction.org/research-resources/voting-matters-2020/

[38] AMNT review into fund managers' voting policies and practices
- https://amnt.org/wp-content/uploads/2019/05/AMNT-final-review-for-FCA-22-May-2019.pdf

[39] WTW found that some large managers spent so little on stewardship that increasing fees by ¼ of a basis point would enable them to increase their budget by a factor of 10 - https://www.willistowerswatson.com/en-GB/Insights/2019/04/investor-stewardship-one-hand-on-the-wheel

[40] Asset managers keep pension trustees in the dark on holding companies to account
https://www.dalriadatrustees.co.uk/asset-managers-keep-pension-trustees-in-the-dark-on-holding-companies-to-account/

[41] Minister for Pensions Guy Opperman's speech on a new direction for trustee stewardship - GOV.UK (www.gov.uk)

Q4. How should the UK seek to share and learn from international best practice?

As the first G7 country to legislate for net-zero and the first economy to mandate climate reporting in line with the recommendations of the Task Force on Climate-related Financial Disclosures, the UK's progress is world leading. The Government recognises the importance of sharing, and learning from, international best practice in this area. We are continuing to share our learnings through speaking events, engaging with the Organisation for Economic Co-Operation and Development (OECD) and through international events including COP26. We will continue to monitor best practice as new examples arise.

The structure of the UK pensions market continues to pose governance challenges to smaller schemes (including managing climate risk). Consolidation will likely address many of these issues, and Government continues to draw on international best practice in that context.

Sharing best practice

50. The UK is the first economy to mandate climate reporting in line with the recommendations of the TCFD. The largest UK pension schemes will, subject to Parliamentary approval of our draft Regulations, be reporting by mid-2022.
51. DWP Ministers have spoken internationally on the lessons learned from managing climate risk with the "PRI in Person" conference in Paris convened by UN Principles for Responsible Investment, as well as to regulators and firms in Turkey and the Middle East.
52. UK Government officials have shared lessons from the implementation of climate change risk management with the OECD, the World Pensions Council and Governments and Regulators from Colombia, Chile and Mexico. Officials also feed in to cross-governmental working groups to inform international collaboration.
53. The key lessons we have sought to share in our engagement are that:
    - Directly managing climate change risk, and therefore indirectly managing climate impacts, is entirely compatible with – and indeed essential to – trustees' fiduciary duty.
    - The fact that climate change risk may be priced in by markets – however unlikely this may seem – is no barrier to requiring pension schemes to consider it and to report on how they have done so.
    - For greatest effectiveness, climate-related disclosures are required along the whole length of the investment chain, from real economy firms, through asset managers to pension funds, insurers and other asset owners.
    - However, gaps in data should not delay action. Several of the TCFD recommendations, including governance and risk management, do not rely on good climate data, and none of them require comprehensive data to draw conclusions. There is enough data to act now.

Priorities for COP26

54. Given the international diversification of pension scheme investments (see Q6), it is in the interests of UK pension schemes for the UK Government to work with other jurisdictions to improve take-up of mandatory climate risk reporting.

55. It is also a key plank of the UK's private finance priorities for COP26, published as Building a Private Finance System for Net Zero[42], for COP signatories to publish pathways to making climate-related financial reporting, based on the TCFD recommendations, mandatory. Last month, the US White House[43] issued an executive order instructing Treasury secretary Janet Yellen to work with the other members of the Financial Stability Oversight Council to issue a report including a discussion of "the necessity of any actions to enhance climate-related disclosures by regulated entities to mitigate climate-related financial risk to the financial system or assets and a recommended implementation plan for taking those actions."

56. We would encourage other countries to set out proposals for mandatory TCFD reporting in due course.

Learning from international best practice

57. The UK can learn from other jurisdictions in terms of the structure of the occupational pensions schemes market. The UK has traditionally had individual company level pension schemes and therefore has more than 8,000 occupational schemes, whereas in other mature markets such as the Netherlands and Australia a multi-employer model is dominant, with around 200 schemes in each jurisdiction.

58. Many reports have referred to the information asymmetry and differentials in market power between small pension schemes and large service providers, particularly asset managers[44].

59. Whilst trustees have a fiduciary duty to manage climate risk on behalf of savers, asset managers predominantly respond to client demand. The considerably more constrained governance resources available to smaller UK occupational pension schemes have tended to encourage a focus on the basics of administration and buying off the shelf investment products, and less focus on horizon scanning of significant or systemic risks, or developing investment solutions which help to mitigate them.

60. This may have directly led to the widespread misperception by some schemes that climate risk was an ethical, non-material or "unpriceable" issue that trustees need take no account of[45].

61. This is still disappointingly reflected in The Pensions Regulator's 2020 DC schemes survey which found that a majority of medium, small and very small schemes were not considering climate change[46].

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[42] COP26-Private-Finance-Hub-Strategy_Nov-2020v4.1.pdf (ukcop26.org)
[43] Executive Order on Climate-Related Financial Risk | The White House
[44] See, for example, the FCA's asset management market study, the Law Commission's report on Pension funds and social investment, Share Action's report on Realigning Interests, Reducing Regulation
[45] See, for example, Sackers-Winmark – Effective governance: the art of balance ,
Professional Pensions Climate change is 'overblown nonsense' and not a material risk, says industry and Hermes Investment Management Responsible investing: the persistent myth of investor sacrifice
[46] The Pensions Regulator. Defined Contribution trust-based pension schemes research

62. Recently Government has consulted on legal duties for DC schemes with < £100m in assets to assess the value for money they offer against larger schemes and to improve or wind-up where they fall short[47]. This measure, which learns from the Australian and Dutch models of consolidation, has the potential to accelerate consolidation in the DC market, where scheme numbers are already falling by 10% a year. In June we laid regulations[48] and published statutory guidance[49], as well as our consultation response[50], alongside a call for evidence[51] on further measures to stimulate further pension scheme consolidation.

63. For DB schemes, where the employer promise creates barriers to consolidation, Government is promoting DB master trusts and will bring forward the next phase of its work on the development of regulation of DB "superfund" consolidators in due course[52].

Report of findings on the 2020 survey

[47] Improving outcomes for members of defined contribution pension schemes

[48] The Occupational Pension Schemes (Administration, Investment, Charges and Governance) (Amendment) Regulations 2021

[49] Completing the annual Value for Members assessment and Reporting of Net Investment Returns

[50] Government response: Improving outcomes for members of defined contribution pension schemes

[51] Future of the defined contribution pension market: the case for greater consolidation

[52] Consolidation of defined benefit pension schemes

Q5. What regulatory changes or other government action has been most effective in delivering change in the UK; and what changes on the part of Governments elsewhere should the UK learn from?

While the UK remains at the forefront of climate disclosure and management internationally, we have sought to learn from previous regulatory change in the UK space when shaping regulations around climate change for pension schemes.

Government action has been most effective where it has been tailored to the UK pension market. When legislating for climate change disclosures, we have been working across government to ensure consistency of metrics. Reporting has been and will continue to be a key driver of this.

64. Our regulations have typically sought to use the power of transparency to drive up the standards of pension scheme governance and consideration of climate risk and opportunities. This recognises that intelligently regulated transparency can help to drive trustee focus on climate risk and improve member and employer engagement by helping to build trust.
65. While (as set out above) the UK is at the forefront of climate change regulation and therefore we are not aware of significant learnings internationally, we have sought to learn from previous domestic regulatory change in shaping climate disclosure regulations.

Lessons learned from the "ESG regulations"

66. We have sought to learn from industry's response and saver outcomes in our first legislative efforts on climate change when taking subsequent steps.
67. In our implementation of the "ESG regulations"[53], we found that whilst the legislation was broadly supported and most pension schemes reported taking the necessary steps to achieve compliance, relatively few schemes made changes to their investment strategy, despite having a year in which to prepare.
68. Research by the UK Sustainable Investment and Finance Association[54] found that very few disclosures by schemes were of high quality. Most referred to ESG being financially material or potentially financially material and delegated both consideration of this

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[53] See the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018 (S.I. 2018/988), which introduced requirements for occupational pension scheme trustees to state in their Statement of Investment Principles their policy in relation to environmental, social and governance considerations, including climate change, and their policies in relation to voting rights, and engagement with asset managers, investee firms and others. See also Clarifying and strengthening investment duties.

[54] Changing course? How pensions are approaching climate change and ESG issues following recent UK reforms

matter and stewardship and engagement to their fund manager without further qualification[55].

69. Responses to letters sent by the Minister for Pensions to 50 large occupational pension schemes in October 2019 found, in contrast, that 71% had gone beyond the minimum requirements, whilst 34% of respondents had gone well beyond[56]. This informed a number of considerations in our development of TCFD reporting proposals that:

- legal requirements which require policy statements alone are vulnerable to boilerplate – our draft Regulations require schemes to undertake the necessary governance activities and to report details of what the trustees have actually done;
- quantitative measures of consideration of climate risk may be more effective in identifying good practice than generic qualitative disclosures – our Statutory Guidance sets the expectation of quantitative climate metrics and working towards quantitative scenario analysis at the earliest opportunity.
- additional time is not necessarily used to develop more effective policy or practice; in response we have offered schemes less time – 4 months for TCFD – to put necessary steps in place when urgent action is required, as it is with climate change;
- larger occupational schemes are more likely to respond to a legislative nudge and go beyond minimum requirements than smaller schemes – our draft Regulations therefore phase in requirements starting with larger schemes, but we have committed to review the inclusion of small schemes in due course, combined with measures to encourage consolidation.

Improving effectiveness of regulations in the future

70. We have worked as part of a cross-government taskforce to ensure consistent climate-related financial disclosures up the investment chain.

71. The Government has committed to review the effectiveness of the TCFD requirements in the Regulations and Statutory Guidance in 2023. This will include the identification of any barriers, gaps and inconsistencies; assessing whether the Regulations remain appropriate, and whether or not they should be extended to smaller schemes.

72. As explained above, Ministers have established a Taskforce on Pension Scheme Voting Implementation to examine these issues and to make recommendations to address them before COP26. As part of its response, DWP will be looking again at stewardship requirements to see if they can be made more effective, to counter the boilerplate and inconsistent disclosures described above.

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[55] We also heard anecdotally that some pension schemes had simply bought boilerplate text from their investment consultants, and that neither the trustees nor their advisers had given serious thought to consideration of climate risk mitigation in their investment decision-making.

[56] See chapter 1 para 27 Taking action on climate risk: improving governance and reporting by occupational pension schemes

Q6. Do pension schemes have suitable information to assess climate risk, or do there need to be international reforms to financial reporting?

Present data coverage does not prevent schemes from taking steps to assess their exposure to climate risk. Quality is improving and our TCFD reporting requirements will accelerate this process significantly.

Whilst trustees are not currently able to obtain full underlying data to inform the calculation of metrics or scenario analysis across their entire portfolio, they can still carry out robust analysis.

Work by international accounting standards organisations is in train to increase the standardisation of decision-useful information for investors. This is particularly relevant for pension schemes given the international nature of their investments.

Domestic requirements on pension schemes

73. Improving the accessibility, coverage and quality of the underlying data required to effectively assess climate risk is undoubtedly a key challenge. It is a challenge which Government has acknowledged when consulting on our TCFD reporting proposals, and one which a number of stakeholders raised in their responses. The Transition Pathway Initiative's 2021 report[57], which assessed whether companies' emissions intensity pathways are aligned with the Paris Agreement goals, found that 16% of the companies they assessed produce 'no or unsuitable disclosures.'
74. However, this challenge and existing data gaps does not excuse or prevent schemes from taking steps to assess their exposure to climate risk as well as building relevant capabilities to ensure as disclosures improve, pension trustees can benefit immediately. Whilst it is currently the case that trustees will not be able to obtain full underlying data to inform the calculation of metrics or scenario analysis across their entire portfolio, data coverage and quality is improving[58].
75. We expect our TCFD reporting requirements to accelerate this process significantly. By focusing our requirements on the largest schemes in the first instance, we anticipate that trustees with the necessary market power will drive continued improvement of disclosures along the whole length of the investment chain. Where pension schemes invest via private markets, we anticipate that the ability to carry out TCFD reporting will become a condition of contract and a point of competition for fund managers and general partners. Moreover, applying the Regulations on a phased basis will allow the wider ecosystem supporting pension trustees to develop.

[57] TPI State of Transition 2021: https://www.transitionpathwayinitiative.org/publications/82.pdf?type=Publication

[58] How can climate change disclosures protect reputation and value? Extract from the 2019 EY Global Climate Risk Disclosure Barometer - https://www.ey.com/en_gl/assurance/how-can-climate-change-disclosures-protect-reputation-and-value

76. Indeed, as mentioned in our answer to Q1, we have already seen more than 20 schemes set ambitious climate targets[59] and trustee-set targets for the effective management of climate risk will in due course be required for more than 300 schemes. They will consequently be reliant on an increased volume and quality of climate disclosures to measure against them. To quote Janine Guillot, chief executive of the Sustainability Accounting Standards Board (SASB) "sustainability disclosure is now at the top of the agenda for the world's largest investors, the world's largest companies and regulators in almost every major market. That's a sea change from where this conversation was even five years ago."[60]

77. The UK Government recognises this in announcing its intention to make TCFD-aligned disclosures mandatory across the economy by 2025, with a significant portion of mandatory requirements in place by 2023.

78. But importantly, the TCFD's recommendations are not a corporate standard. So they will not drive the consistency and comparability of reporting that the markets – and institutional investors along the investment chain – need to make informed decisions. Implementation of the TCFD's recommendations should therefore be seen as an important milestone on the pathway towards international corporate reporting standards on climate change and wider sustainability related matters, that is under development by the IFRS Foundation.

International investment and standards

79. Pension schemes are internationally diversified, with overseas investment being a key element of the investment strategy, especially in relation to equities[61].

80. A 2021 study by the Pensions Policy Institute (PPI)[62] found that among DC schemes, international allocations have grown, and are likely to continue to do so as these schemes increase in assets. This is significant as the availability of reliable climate-related data varies significantly between jurisdictions, and progress toward global reporting standards is important to address this gap.

81. This is undoubtedly a challenge for ever more diversified DC schemes, however it is by no means an insurmountable barrier to climate risk assessments being carried out. The PPI highlight in the same report that even with the development of global reporting standards, it is likely that reporting practices will continue to vary to some extent for the foreseeable future. Schemes therefore cannot afford to delay assessing their climate risk in anticipation of international disclosure reforms, which although important and necessary, will not eradicate jurisdictional discrepancies entirely.

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[59] Global framework for investors to achieve net zero emissions alignment launched – $8 trillion investors put it into practice – IIGCC

[60] Financial Times Report: 'Measuring what matters'

[61] Estimates vary between 70 and 80% of quoted equity investments are invested overseas. See figure 7.5 of The Purple Book 2020 (ppf.co.uk) [DB schemes] and figure 23 of UK pension surveys: redevelopment and 2019 results [direct holdings of equities across all schemes]

[62] PPI: How do UK pension schemes approach investment into overseas assets? https://www.pensionspolicyinstitute.org.uk/media/3777/2021-03-26-how-do-uk-pension-schemes-approach-investment-into-overseas-assets.pdf

82. Recognising that individual jurisdictions are at different stages in their sustainability journeys, and have different public policy objectives, fully internationally aligned reporting standards will be difficult to achieve. To accommodate such differences, the International Organization of Securities Commissions (IOSCO) has promoted a 'building blocks' approach, whereby a common global baseline of standards can be complemented by jurisdiction-specific requirements as necessary. The TCFD and more recently the Trustees of the International Financial Reporting Standards (IFRS) Foundation have already created a global consensus that better climate data is needed, and work is well underway to agree a global baseline of standards for sustainability disclosures.
83. This is a hugely significant development for UK pension schemes with global investments, especially taking into account the 'climate-first' and 'investor focus' of the prospective board's scope, which aligns well with the DWP's draft Regulations and the TCFD's recommended reporting requirements.
84. The International Sustainability Standards Board (ISSB) offers the prospect for greater standardisation of reporting in the near future as well as providing a standard from which an audit and assurance framework can be developed to further support the reliability of issuers' disclosures. In the meantime, there is broad agreement across the industry that trustees can and should still assess their exposure to climate risk based on the current data available. They should continue to demand better data coverage, through engagement with asset managers and investee firms, but waiting for further standardisation to emerge is not a credible reason for delay.

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