ASSOCIATION OF CONSULTING ACTUARIES

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Emma Walmsley, Tom Rhodes and David Farrar
Climate Change and Responsible Investment Team
DWP
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Dear Emma, Tom and David

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

I am writing on behalf of the **Association of Consulting Actuaries (ACA)** in response to the above-named consultation issued by DWP.

Our comments on specific questions raised in the consultation are set out below.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. In that event, please contact me on 07799 893 797 or at stewart.hastie@isio.com

Yours sincerely

Stewart Hastie
Chair, Climate Risk Group and Honorary Treasurer
On behalf of the Association of Consulting Actuaries Limited

ACA response to DWP consultation – taking action on climate risk: improving governance and reporting by occupational pension schemes

General points

Overall, there are a number of refinements which are a positive response to some of the practical issues identified and the proposed statutory guidance is helpful. It's clear that the Government expects all schemes to start considering climate risks, with the larger schemes needing to disclose first. The guidance is intentionally aspirational at the current time – which we support – and this has helpfully been acknowledged with the repeated 'as far as they are able to' provision.

There remains a lot for trustees to take in and do. They will be relying on an industry that is still working out exactly what is available, what is relevant and how to assess the impact of future climate scenarios.

Perhaps inevitably, given the Government's ambitions for change and the utter scale of the wider issue of climate change, there remains a risk of spurious data gathering and calculations. We also discuss the risk of a herd mentality when it comes to metrics and targets below. Finally, we have some concerns around the possibility of disproportionately diverting trustee's resources away from focussing on other major pensions risks.

The Pensions Regulator (and advisers) will have a major role to play in helping schemes understand what 'good enough' looks like, especially over the next few years and whilst HMT's TCFD roadmap is implemented.

Lastly, we believe this a major opportunity to engage scheme members in their pensions savings. We suggest the inclusion of additional non-statutory, 'best practice' guidance on how schemes could provide simplified but engaging information to members off the back of TCFD reporting to engage members in their benefits and climate change.

Many of the points below straddle more than one of the chapters. We've therefore grouped our points slightly differently to the suggested questions, but in a way that we hope is nonetheless easy to collate and digest.

Changes made relative to the August 2020 consultation proposals

We are broadly supportive of many of the changes made versus the August 2020 consultation, including a number that the ACA (and others) suggested. Some specific comments:

a) *Scope and timing* – it is helpful that bulk annuity contracts have been carved out from the definition of reference assets. Likewise, the blanket 7-month timetable from scheme year-end for schemes to publish their TCFD report is welcome.
b) *Governance* – the clarification around "persons managing the scheme" is helpful.
c) *Frequency for metrics and targets* – we believe the move to annual calculations and reporting from quarterly strikes the right balance. However, we'd welcome clarification on whether the annual metrics and scenario analysis needs to be carried out at the same reference point/effective date each year. (We can imagine, especially at first, that data the trustees obtain may not be at the same reference point year on year, especially if their investment manager(s) are implementing new processes).
d) *"As far as they are able to"* – having this explicitly defined in the regulations and statutory guidance is welcome. Likewise, we agree with the extension of the provision not just to the collation of data but also calculations, use of metrics, performance against targets and scenario analysis. We anticipate that trustees will prioritise improving data / analysis

availability over time, but the provision allows trustees the use of approximations or a qualitative approach in the meantime.

e) *Climate risk impact on funding strategy / covenant* – the recognition of the practical challenges with this analysis and the emphasis on qualitative as well as quantitative analysis is helpful.

f) *Impact assessment* – although it's clear that feedback from the initial consultation has been heard via the recognition that costs may be slightly higher than suggested, we believe many trustees will find that actual costs will be higher than those suggested (at least initially), and the time commitment required may prove a distraction from other activities, at least in the short term.

Strategy – time horizons

- The regulations and statutory guidance contain the factors that trustees must consider when determining their time horizons. However, we feel that the level of detail provided is unlikely to be helpful to most trustees and therefore more detail or prescription would be preferred.

Proportionality of risk management processes

- The regulations and statutory guidance recognise the need for climate risk to be integrated into trustees' wider risk management framework.
- Although the new trustee knowledge and understanding requirement is described as 'best practice' and can be considered non-statutory guidance, we think the standard being asked for elsewhere in the documentation is of a considerable higher level than for other major pension scheme risks. Namely, Part 3, paragraph 88 of the statutory guidance lists a number of very detailed expectations on trustees.
- We believe it is important that the time spent considering climate risk should be complemented by time and resources spent considering other major risks, including the 'S' and 'G' of ESG, and not at the expense of them.

Level of analysis required (strategy, scenario analysis, metrics, targets)

- It is helpful that trustees of DB schemes with segregated sections can group analysis where the sections share similar characteristics, including their time horizons. We hope this will go some way to avoid the scenario of a £1bn scheme with three segregated sections, say, needing to prepare and disclose three separate reports compared to one report for a single section £1bn scheme and no report for a £900m scheme.
- For DC schemes, the clarity around "popular" default funds is welcome. However, with only 250 members invested being the criteria, we anticipate this leading to a large number of funds falling into the requirements for larger schemes and most master trusts, and it therefore being an unpopular threshold.
- We would welcome further clarifications for 'blended' funds, common in DC schemes. For example, investment platforms regularly offer funds with 5-6 different fund managers' funds wrapped together and branded as a single "XYZ Scheme Growth Fund", say. In this example, the scheme's trustees will have no contractual relationship (and often no contact) with the constituent fund managers, their only contact is with the platform host. If the intention is for the platform host to contact the constituent fund managers, aggregate the information and provide that to the trustees, it would be helpful if this was clarified.

Frequency of scenario analysis

- The statutory guidance (namely Part 3, paragraph 78) lists a comprehensive number of factors that might lead trustees to undertake analysis in years where it is not mandatory. Our view is that one or more of these factors is likely to 'bite' in any one year, and so the guidance will be perceived by some trustees of a requirement to undertake an annual exercise by default. We suggest some relaxation to this wording, perhaps changing the statutory guidance to say "*Circumstances which are likely to lead trustees to decide that new scenario analysis may be undertaken in a year where it is not mandatory*" and explicitly allowing trustees to consider the materiality of the likely change to the analysis as a result of the new information.
- The statutory guidance and regulations could serve to dissuade schemes of >£1bn from considering climate risk before they are required to under the regulations, which would be an unfortunate consequence of the drafting. For example, if a >£1bn scheme commissions the required analysis in early 2022, then they would be required to re-do the analysis for their first required report a year later in 2023. We suggest the requirements are amended so that the first report that is disclosed must contain analysis that has been carried out within 3 years of the date of the report, with the analysis repeated every three years thereafter (subject to the annual review).

Assets included within scenario analysis and metrics/targets

- *Bulk and individual annuities* – as noted above, it is helpful that these have been excluded from the reference assets test. However, the regulations still intend for them to be included within the scheme's scenario analysis. We don't believe that this will serve to add value to trustees in these cases. This is because the scheme is 'locked in' with their chosen insurance provider, and therefore is not in a position to change this. We suggest that it is made clearer that a qualitative analysis is likely to be appropriate for annuity contracts, or that including them within the quantitative analysis is optional. We would expect trustees to consider the climate risk policies of insurers as part of the selection process for future transactions.
- *Derivatives* – we would appreciate further guidance on the requirements for derivatives which are collateralised on a daily basis (for example interest rate and inflation swaps), because climate risk exposure of the underlying counterparties will be minimal, given the daily collateralisation, and there is little value in assessing the exposure relative to the time and cost of doing so.
- *Gilts* – we believe most DB scheme trustees are highly unlikely to sell their gilt holdings on the account of their climate risk exposure. They will invest in gilts to reduce their interest rate and inflation risk exposures, which are material over all time horizons and can have a significant impact on scheme funding if not managed effectively. The assessment of the likelihood of the UK Government defaulting on a gilt payment as a result of climate change should be carried out by the UK Government and not by trustees. We recognise that the suggested sovereign bond metrics are more relevant where the bond holdings are instead for overseas governments.

Metrics and targets

- We were pleased to read the additional guidance contained in the statutory guidance relating to how trustees should determine appropriate metrics compared to the August 2020 materials. The flexibility to calculate metrics at an asset class or sector level rather than at the portfolio level is welcome.

- However, we are concerned that most schemes will choose similar metrics based on ease of calculation, at least initially (for example, the data quality metric), rather than by the potential to reduce climate risk or ultimately fight climate change.
- Assuming the legislation aims to both reduce pension scheme's climate risk exposures and also reduce climate change overall, we believe further guidance on how to select appropriate metrics would be helpful. For example, it would seem reasonable for trustees to need to take advice and provide commentary on whether / how their chosen metrics are expected to reduce climate risk or climate change, even if this was qualitatively. It will be fundamental for trustees to fully appreciate what their metrics do and do not show, and to look at all metrics in total, before setting targets or making investment decisions based on the metrics.
- We believe that this requirement could serve to encourage accelerated development of these metrics by fund managers and helps to avoid the risk of climate risk reporting becoming more of a compliance activity rather than aligned to overall policy aims.

Disclosure and member communication

- The statutory guidance sets out how a public access website link to the TCFD report is included in the scheme's annual report and accounts. This is helpful, and when combined with the 'Plain English' summary within that report, will hopefully serve to increase member engagement.
- However, as in our response to the August consultation, we believe that climate change reporting is a major opportunity to proactively engage members with their retirement savings. We would welcome additional non-statutory, 'best practice' guidance on how schemes could provide simplified but engaging information to members off the back of TCFD reporting to engage members in their benefits and climate change. Arguably, this is even more important for DC schemes than DB, given the investment choices afforded to members and direct impact on members' benefit outcomes.

Role of TPR

- As in our response to the August consultation, we would be supportive of the Regulator publishing an annual statement on climate risk to help establish good practice as the data, resources and metrics/targets available evolve over time.