ASSOCIATION OF CONSULTING ACTUARIES

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David Farrar
Policy Lead
Climate Governance & ESG
Department for Work & Pensions

Dear Sirs

Aligning your pension scheme with TCFD recommendations: a consultation on guidance

I am writing on behalf of the Association of Consulting Actuaries in response to the above-named consultation.

Our comments on specific questions raised in the consultation are set out in the Appendix. We have only included those questions on which we had comments.

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 893797 or at stewart.hastie@isio.com

Yours sincerely

Stewart Hastie
Chair, Climate Group
On behalf of the Association of Consulting Actuaries Limited

About the Association of Consulting Actuaries (ACA)

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

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Appendix: ACA responses to the consultation questions

4. What do you like about the guidance? / What is most useful?

We are very supportive of this guidance and are positive on the genuine changes it could bring about over the longer term. There is a significant amount of information contained in the report that a wide range of stakeholders will find useful, particularly to help understand where climate change risks could arise (that may not be obvious) and the nature of those risks. An example of this is the clear delineation between transition and physical risks that will likely bring the risks more "front of mind" for many trustees given that even those with shorter timescales could be confronted with transition risks.

We believe the concept of the layout is useful with the clear actions for trustees set out at the end of the relevant sections. This will be helpful to trustees, although we do have some views below on how the level of implementation could be maximized that we outline in our response to question 5.

There is a clear message that, within a defined contribution scheme, trustees must not leave the consideration of climate change to members via self-select funds. We believe it is important that such considerations be integrated in default investment strategies, where the majority of capital is likely to be invested.

5. What don't you like about the guidance? / What needs improving the most?

Our key comments on improvements are mainly around making this as accessible as possible and the benefits as clear as possible across the spectrum of trustees and pension schemes, creating the highest probability of this being fully integrated into decision making.

There are clear actions and related disclosure requirements for trustees set out at the end of the relevant sections and, as industry professionals helping trustee boards to assess and manage risk, we believe this guide will be very helpful for trustee boards with the resources and experience necessary to adopt the recommendations. However, in our view, many trustee boards will struggle to meet the high level of minimum requirements contained in the guide. As an example, the sections on what constitutes "leadership" compared to "minimum standards" are extremely short in comparison to the other actions. To help encourage engagement and early adoption rates, we suggest it would be beneficial to have a more graduated scale of actions constituting minimum, expected and leadership standards. This could be done on a scoring system of 1 – 5 with a score of 5 for a trustee board showing true leadership in this area.

Our view is that implementing a more graduated approach will both allow trustees to bring this in over time, and will also provide feedback on what they are doing to gradually increase the engagement. Disclosure of where the scheme is on the scale will help to provide extra stimulus for schemes to improve further over time, either from members or other stakeholders and allow the 'leadership' benchmark to evolve.

We also feel it would be beneficial to provide a clear "so what?" from each of the suggested actions to allow trustees to prioritise their actions and focus on those with the biggest impact first. For example, should the

guidance help trustees understand whether reviewing voting policies or having a clear figure for a portfolio's carbon emissions make more sense to action first.

Overall, we do not believe it is the content that needs revision but rather the implementation plan for trustee boards.

6. Is the current structure helpful?

- Having summary tables for the relevant sections linked to the TCFD framework will be helpful for users. Using the TCFD framework for the structure of this would help in consolidating the information in the guidance note. The summary tables reference the sub-points from the TCFD – it would help if they were transposed into a structure that covers governance, strategy, risk management and targets - against metrics with what's required under the 1-5 scoring system that we have suggested.
- In general, there is a lot of information to assimilate, meaning it may not be effective in achieving mass take-up. Specifically, we are concerned that it may be difficult for many small and medium size trustee boards to use this in practice.

7. Does this guidance provide schemes with everything they need to: a) manage climate risks b) disclose in line with the TCFD recommendations?

- Having clarity on the prescribed scenarios and metrics under the Pensions Schemes Bill will help with the understanding of what will be required of trustees as a minimum, avoiding potential unnecessary expenditure from commissioning scenario modelling of climate scenarios that don't meet the Government's prescribed bases.
- There is an emphasis on making statements and producing numbers, but it is less clear how trustees will determine whether the numbers are leading to the desired outcome. For example, understanding how a particular action helps to manage climate risk rather than just improving a particular metric.
- In that respect we feel that there is sufficient detail to achieve b) however in respect of a) there is less information on how to weigh up the benefits and disadvantages of different management measures, e.g. is disinvesting from fossil fuel-linked investments the best way to manage a particular risk.

- For the many schemes that invest in pooled funds, even a strong desire to manage climate risks may be hampered by the availability of suitable funds (that also meet the trustees' other criteria). We note that there is a 'demand' and 'supply' balance at play here – demand from trustees, 'supply' from the fund management industry.

8. Have we missed anything?

- As noted above, in our earlier answers, we suggest it would be helpful to provide a grading system. For example, schemes which have attained the top level 5 (say) would be considered to have fully adopted the 11 TCFD recommendations and/or implemented all of the suggested trustee actions under the various headings in the guidance (investment beliefs, investment strategy, stewardship, covenant and funding, review). The guidance would indicate which subset of the full list of suggested trustee actions would then imply levels 1 to 5 compliance to give a steer on a set of priorities and a pathway to full adoption. These subsets can be designed to prioritise those actions that are felt to have the most significant positive impact balanced with ability to achieve. The language used in describing the levels and subsequent disclosure to members could also be used to drive behaviour and higher attainment over time. For example, level 1 could be "basic minimum", level 2 could be "positive start", etc. up to level 5 "leadership".
- It would be helpful to set out more clearly what constitutes a 'smaller scheme', and what the difference in expectation is for such schemes. Examples would be helpful.
- It would be useful to have some comments on how passive investing (which achieves other objectives i.e. reduces fees) interacts with trying to reduce carbon weighting of the portfolio, and what the expectations are for trustees who are primarily passive investors. As an example, you could discuss the trade-off of selecting a large passive manager who buys the index, but then interacts strongly with the underlying companies to manage climate risks. Equally there could be some discussion on the climate tilted index-trackers which are beginning to emerge.
- The guidance is more focused towards DB than DC. However, the actions of DC trustees may have a significant industry impact. The guidance could highlight more actions for DC default arrangements.

9. Part I - Please provide any comments on “Introduction - Understanding climate change as a financial risk”

- We would expect more quantitative benchmarks to help trustees understand what ‘good’ (or level 1-5) looks like.
- It is important to back up sections such as ‘is climate risk priced in?’ with more evidence, to help trustees understand the impact of climate risk under different scenarios.
- Whilst climate change is a systemic risk and important for trustees to place weight on when making investment decisions, it needs to be recognised that schemes face a variety of other financial and demographic risks. The perception of some trustees and advisers, rightly or wrongly, may be that climate risk is a secondary consideration to interest rate risk, for example. It may therefore be worth a general discussion on the contrasting nature of the various risks typically faced by pension schemes, drawing out the point that interest or inflation risk are daily market risks that are well understood and for which controls and mitigations are readily available, whereas climate risk is potentially a catastrophic risk type, which unfolds in a completely different manner, is systemic, and as such is not comparable to daily market risks which still need to be managed in addition to climate risk.

10. Part I - Please provide any comments on “The legal requirements on pension trustees”

- We expect that trustees will take legal advice on this area. To help address this, it would help to have a table setting out in one place the key requirements, including early indications of the climate-related regulations in the Pensions Schemes Bill.

11. Part I - Please provide any comments on “The TCFD Recommendations”

- Subject to the Pensions Schemes Bill, it would be useful to give a steer on timelines.

12. Part II - Please provide any comments on "Defining climate-related investment beliefs"

- Given the number of trustee boards and different advisers, the guidance will likely result in multiple different beliefs (of which many may be similar but have small differences). If an investment manager is presented with multiple different beliefs, they may struggle to reflect them all or even be clear on where the majority lie. It may help if there were prescribed categories of scheme beliefs that would cover most cases, enabling trustees to clearly set out to their investment managers what they want to see and do. Part of the issue is that in practice the language of climate risk, "green bonds", "sustainable finance" etc. is confusing, and inconsistently applied. It may therefore be worth referencing the work that has been done at EU level to develop a taxonomy in order to define performance thresholds and identify activities which will help to grow low-carbon sectors and decarbonise high-carbon ones. See https://ec.europa.eu/info/publications/sustainable-finance-teg-taxonomy_en.
- Ultimately it may need to be mandated through the Pensions Schemes Bill that there is a social imperative for considering climate change (rather than purely risk/return for individual schemes), and that pension schemes must explain how their actions are consistent with keeping global warming to less than 2 degrees.
- It is important to recognise that many sponsors will have their own beliefs and targets on climate change, which trustees should understand and take into account.
- It should also be noted that this is a very complex area and trustees have limited governance time which means that defining high level beliefs is feasible but for many boards it will be difficult to define more intricate views. As noted in previous answers the focus should be on ensuring the actions with the largest benefits should be carried out first.

13. Part II - Please provide any comments on "Climate-related risks in investment strategy and manager selection"

- We would suggest that there is more focus on outcomes, as well as how to achieve these and assess whether they have been met, e.g. is it expected that an intermediary will be appointed to score managers? Consideration could also be given as to whether to set a central quantitative target(s) to manage climate related financial risks and opportunities.

- Some other specific points are set out below:
  - This section could be where it is set out how to compare climate risks to other risks.
  - While risk profiles are acknowledged, any adaptation of the guidance for this should be limited if a change is expected to be made.
  - It would be good to set out the difference between volatility and long-term scenario risk.
  - If passive funds are not market weighted, trustees will need to be careful of costs when rebalancing.
- We feel that a consistent way across the industry of benchmarking managers will be very beneficial because, at the moment, managers can select their own metrics and it can be difficult for trustees to compare.
- The checklist that has been provided is very long. Similar to other comments, it could this be condensed into the essentials, 'nice to haves' and more periphery requirements to help prioritise actions and encourage adoption.
- When interacting with managers it would be useful and more efficient to have some industry standards, in terms of specific requests of managers to facilitate wider adoption and change.
- Models will develop over time, and both qualitative and quantitative models need to be considered – in respect of this, we believe it should be noted that models should be considered with care. Trustees may place too much focus on quantitative models that give a numerical (but not necessarily more accurate) result.
- Many defined contribution schemes appoint an investment platform provider and invest in a range of funds through the platform, rather than appointing investment managers directly. Clarity on the duties in relation to investment platforms and non "appointed" (but "selected") managers would be helpful.

14. Part II - Please provide any comments on "Stewardship on climate issues"

- It would be helpful for trustees to see a record of how managers vote – whether they tend to be climate change positive, negative or neutral. It would be beneficial to have a more standardised way of reporting on voting such that trustee boards can evaluate some clear metrics. Related to this, it would be helpful to set out what climate related metrics or reporting trustees should get from managers as a minimum, and any guidance on what to look out for.

- It should be acknowledged that specialised mandates have more power over voting, so schemes in this position can potentially go further in their actions.
- Despite this, it is worth noting that owners of passive funds will typically have greater holdings in underlying companies and presenting a united view to asset managers may therefore have more impact.

15. Part II - Please provide any comments on "Additional points for DB schemes"

- Climate risks are likely to be long term so should be balanced against other objectives, e.g. the ability to buy-out by taking more risk in the short term.
- For actuaries to take climate risk into account in valuing liabilities, we would appreciate some guidance around how to do this and what level of advice is expected. This is an inherently challenging concept, given the dominance of other fundamental economic events that can drive the movements of interest rates and inflation.
- This valuation guidance should be specific. The temptation to suggest an arbitrary margin of prudence should be avoided because to do so would blur the benefits of incorporating climate risks into the management of UK pension schemes.
- It should be noted that trustees assessing their sponsor's covenant in the context of climate risk may be constrained in what they disclose publicly, particularly for those sponsors with specific corporate disclosure requirements.

16. Part II - Please provide any comments on "Reporting and member communications"

- With any member communication, it will be important to make sure the communications are clear to members and not misleading. The 1-5 scale we have suggested will help with communicating the trustees' actions to members in a clear way.
- In particular, for DC members, they will need to make informed choices on their own investments. The default is important but those with stronger views will need to

understand how to reflect this by investing in self-select funds – and how those funds rate in terms of their impact on climate.

- Climate considerations could help to engage members, but the metrics and terminology can be complex, and care should be taken to ensure such communications are consistent and written with members in mind, free of jargon (for example "TCFD"). Thought should also be given to what communications should be used for these messages – e.g. annual benefit statements are likely to "reach" members (given their personalised nature) more effectively than Chair's Statements.
- Where possible the language of member communications should be 'positive' in the sense the benefits of a course of action are prominent, rather than 'negative' which might focus more on the risks mitigated. This must of course be balanced (and accurate)! The guidance could potentially highlight this more, perhaps giving some examples.

17. Part III - Please provide any comments on "Scenario analysis"

- There is a risk that if many schemes use similar models they could end up with the same results – this could end up with lots of schemes investing in the same industry, resulting in concentration risk.
- The case study is an example of how this could lead to some strange results, for example 'buy and maintain' is shown as having lower risk than equity, despite having a smaller universe and much less buffer than equity.
- We think rating a whole asset class as equities/bonds needs to be undertaken very carefully as they can be made of up a significant range of different companies and sectors. Certain areas such as long-dated bonds are more concentrated, and it is in these cases that schemes will need to be more careful.
- Prescription around the broad characteristics of a scenario to be modelled would be helpful to get consistency across schemes, even if the underlying modelling tools are different across the industry.
- Stress tests around climate impacts (particularly over a shorter time horizon) will be more important than relying on scenario testing alone.
- It is important to point out that trustees should consider a range of analysis – if the results vary significantly then care needs to be taken.

18. Part III - Please provide any comments on "Metrics and Targets"

- We suggest it would be helpful to provide analysis on why these metrics are beneficial, for example GHG? Whilst there is no doubt that reducing GHG is important, we expect that trustees would find it useful to understand the benefits of reducing these metrics and in turn make them more likely to apply the metrics and risk management in the guidance.
- It would be helpful to understand through a range of metrics what outputs are considered good or as needing further action.

19. Part III - Please provide any comments on the appendices

None

20. Please provide any comments on the Quick start guide

- Having the additional short guide is useful, however it would not be sufficient for trustees to fully understand their obligations. It should be made clear that this is a "start guide" and that trustees seeking to better understand and manage climate related risks will need to undertake further reading and engagement.

21. Case Studies - We would welcome any case studies on TCFD-aligned disclosure and integration of climate-related risk assessment and management into decision making and reporting. Please provide an overview of any case studies you wish to submit below.

None to be provided by the ACA.

Response from:

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