CONSULTATION ON POLICY, REGULATION AND GUIDANCE

CLIMATE AND INVESTMENT REPORTING: SETTING EXPECTATIONS AND EMPOWERING SAVERS

RESPONSE FROM THE PENSION PROTECTION FUND

DECEMBER 2021

About the PPF

The Pension Protection Fund (PPF) was established to pay compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation. The PPF is a statutory fund run by the Board of the PPF, a statutory corporation established under the provisions of the Pensions Act 2004. The PPF became operational on 6 April 2005.

On 10 July 2009 the Board of the PPF was also given the responsibility of being the scheme manager for the Financial Assistance Scheme (FAS). FAS provides assistance to members of eligible underfunded defined benefit schemes that started to wind-up between 1 January 1997 and 5 April 2005, or between 6 April 2005 and 27 March 2014 where an employer insolvency event occurred before 6 April 2005.

PPF response

Chapter 1 – Measuring and Reporting Paris Alignment

Q1. We propose to amend the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 to require trustees of schemes in scope to measure and report their scheme's Paris alignment by adding a requirement for them to select and calculate a portfolio alignment metric and to report on that metric in their TCFD report.

Do you agree with this policy proposal?

The PPF is supportive of the policy proposal for trustees of schemes to measure their portfolio alignment in principle. We acknowledge the urgency of acting within investments and the necessity to consider forward-looking measures in order to manage climate exposures effectively.

However, we wish to share a few important issues that we feel are essential to consider to avoid potential misinformation to schemes' members, in terms of the suite of metrics proposed as measures of portfolio alignment, e.g. binary target measurement, benchmark divergence model and implied temperature rise (ITR).

The PPF welcomes the fact that a range of choices are offered, however we feel it is worth noting that all of these metrics require different data sources and assumptions to be made, and are far from comparable. It is essential to ensure that there is enough information and education provided on the matter (both to the users and consumers of such information), since it will be hard to compare different schemes. In addition, we do not view one single output or metric on its own as a silver bullet, and we ourselves are utilising a range of metrics to arrive at a more informed and holistic assessment of portfolio alignment. By way of background, carbon footprinting metrics of investments took many years to reach common industry agreement - the PRI and UN launched the Montreal Carbon Pledge for portfolio carbon footprinting in 2014 yet the PCAF carbon accounting standard for portfolio carbon footprinting was only finalised at the end of 2020.

Data availability is one of the greatest challenges in measuring portfolio alignment, especially for the benchmark divergence and ITR models, and it should be acknowledged that most of the data is currently only available for the public equity and corporate fixed income asset classes (and only in certain sectors for benchmark divergence models). The data for other asset classes is currently based on proxies, thus the data quality is far from granular and transparent.

The binary target measure of aligned/non-aligned does provide the most simple and cost-effective approach to measure alignment, however it is open to reliance on companies committing rather than actually delivering real emissions reductions, and it also does not provide an assessment of *how* misaligned the non-aligned companies are. It is also rather different than the highly complicated methodology of calculating ITR, which is based on several assumptions. Thus, we feel it is appropriate to ensure that trustees are acquainted with the intricacies of the methodologies and are able to communicate these clearly to their members and stakeholders.

We recommend that DWP considers allowing for a broader portfolio coverage metric - as a share of the portfolio – such as the approach included in the Institutional Investors Group on Climate Change (IIGCC) Net Zero Investment Framework (NZIF). The NZIF portfolio coverage metric is more versatile than the binary metric and would allow for flexibility and inclusivity around the transitioning companies that might be non-aligned today but at least are transitioning in the right direction, and in setting an objective to gradually increase the alignment (e.g. from 25% through 50% to 75%). This would help to avoid unintended consequences of schemes feeling compelled to divest today from non-aligned companies, instead permitting them to hold companies that are in the process of alignment, and ensure that they arrive at their desired outcome through active and vigilant stewardship. The PPF welcomes the emphasis on stewardship over divestment as a rule, and we are supportive of initiatives that have been established to support investors on this, such as the IIGCC's development of a net-zero stewardship toolkit, which we are involved in designing.

The PPF is supportive of the use of an ITR metric as one of a number of measures for assessing the forward-looking nature of individual companies/assets in establishing their alignment and informing stewardship plans. We believe that there is merit to carrying out bottom-up company by company analysis through the lens of ITR, as it can provide a granular view and insight on the most contributing companies in a portfolio. This enables identification of the most prominent targets for active engagement. However, through our own hands-on work to calculate ITR scores for our Fund across asset classes, we have experienced that the available methodologies are heterogenous, introduce various and differing assumptions on the state of the world and economies, and can be complicated and challenging to transparently explain. The many assumptions built into the underlying data and tools can also be magnified considerably when aggregated at a portfolio level.

Considering all of the above points, if DWP proceeds with mandating the disclosure of a portfolio alignment metric at this stage, the PPF recommends that the binary alignment measure, or ideally the portfolio coverage measure be stipulated initially. If any schemes are minded to go further than this with the other proposed measures, the measurements of portfolio alignment could be provided on a voluntary basis until there is more agreement on methodologies, however they should also provide disclosure of what measurement(s) and assumptions have been used. This would allow schemes to apply alignment assessments with caution and gain an internal understanding of the results first. Should the scheme wish to provide enough information on the results and methodology used, they can decide to publish it in their TCFD report. This will allow for schemes to acquaint themselves with the intricacies of the methodologies without unintentionally misleading members.

Q2. We propose that

(a) trustees who are subject to the requirements in Part 1 of the Schedule to the Climate Change Governance and Reporting Regulations on or after 1 October 2022 (including trustees to whom the requirements are re-applied in accordance with regulation 3(4), 4(4) or 5(4)) will be required to select, calculate and report on a portfolio-alignment metric and to publish the findings in their TCFD report within 7 months of the relevant scheme year end date in the same way as they are for other metrics. This will apply to:

- trustees of a trust scheme which had relevant assets equal to, or exceeding, £5 billion on their first scheme year end date which falls on or after 1st March 2020, and who remain subject to the requirements in Part 1 of the Schedule on 1 October 2022;

- trustees of a trust scheme which has relevant assets equal to, or exceeding, £1 billion on a scheme year end date which falls on or after 1st March 2021; and

- trustees of all authorised master trusts and authorised collective defined contribution schemes.

After 1 October 2022

(b) trustees will cease to be subject to the requirements to select, calculate and report on a portfolio alignment metric in accordance with regulations 3(4), 4(3), 4(5), 5(3) and 5(5) of the Climate Change Governance and Reporting Regulations:

- trustees of a scheme with relevant assets of less than £500m on a scheme year end date which falls after 1 October 2022 will cease to be subject to the requirements to select and calculate a portfolio alignment metric with immediate effect, but must still report on their selected portfolio alignment metric in their TCFD report for the scheme year which has just ended, unless the relevant assets on the scheme year end date were zero;

- trustees of an authorised scheme which ceases to be authorised after 1 October 2022 (a "formerly authorised scheme") and which had relevant assets of less than £500m on the scheme year end date immediately preceding the scheme year in 51 which authorisation ceased, will cease to be subject to the requirements to select, calculate and report on a portfolio alignment metric with immediate effect;

- trustees of a formerly authorised scheme which has relevant assets of less than £500m on a scheme year end date after authorisation ceased, will cease to be subject to the requirements to select and calculate a portfolio alignment metric with immediate effect, but must still report on their selected portfolio alignment metric in their TCFD report for the scheme year which has just ended, unless the relevant assets on the scheme year end date were zero.

Do you agree with these policy proposals?

The PPF believes it is important to ensure that any requirements of reporting for asset owners are coordinated and clearly sequenced with the requirements for FCA regulated asset managers to report in line with TCFD.

Schemes are already under significant pressure to report to various regulatory and non-regulatory bodies, and they should be able to rely on sourcing information from their asset managers, to manage both costs and resourcing needs. From our own experience, at the moment, it is not feasible for schemes to calculate aggregated Fund level portfolio alignment metrics based only on the information that our asset managers can currently provide to us. This was a significant factor in our decision to initiate our own bottom-up portfolio alignment project.

Therefore, we support the proposed timelines in principle, if only being applied to the binary measure.

Q3. We propose to incorporate the requirements to measure and report a portfolio alignment metric into the existing Climate Change Governance and Reporting Regulations so that the requirements are subject to the same disclosure and enforcement provisions as the other metrics requirements.

Do you agree with this policy proposal?

The PPF supports the introduction of portfolio alignment metrics as a measure for climate compliance, however as stated above, would suggest DWP not mandate the publication of these metrics beyond the binary measure as yet, while agreed methodologies are still in their infancy.

As expressed in our response to Q1, the methodologies around forward-looking metrics are still developing and so is the understanding of them. Given this, we feel imposing a penalty by TPR for not disclosing how the scheme has measured portfolio alignment in a dedicated TCFD report should be considered only as a very last resort, at least for the first year or two of disclosure.

Q4. (a) Do you have any comments on the draft amendments to the Regulations?

(b) Do you have any comments on the draft amendments to the statutory guidance? Please include in your answer any comments you have on whether you consider that they meet the policy intent stated in this chapter.

We particularly welcome comments on the definition of a portfolio alignment metric and whether respondents think it reflects the policy intent?

"portfolio alignment metric" means a metric which gives the alignment of the schemes' assets with the climate change goal of limiting the increase in the global average temperature to 1.5 degrees Celsius above pre-industrial levels.

The PPF supports the definition of the portfolio alignment metric and approves of the clarity on defining the targeted threshold as 1.5 degrees Celsius. It is essential to establish this threshold as the target – the interpretation of the Paris Agreement was initially focused on the goal of keeping the global average temperature rise to below 2 degrees, but since the IPCC special report in 2018, the focus has now shifted to 1.5 degrees as congruent with Net Zero alignment.

The PPF agrees on using portfolio alignment metric(s) as a tool for meaningful assessment of climate-related risks and opportunities, with the goal of identifying and engaging with specific companies.

The PPF would like to share our experience that one single portfolio alignment metric/methodology cannot currently be applied consistently across all asset classes. Gradual development of methodologies is necessary in order to achieve greater coverage of a portfolio beyond listed equity and corporate fixed income.

The PPF would like to highlight the following asset-specific concerns and recommendations:

- Assessing alignment exposures through derivatives such as synthetic ETFs is problematic for a couple of reasons. Firstly, the investor is detached from the underlying holding and it is challenging to allocate ownership of that holding. Secondly, for some synthetic versions based on swaps, the underlying holdings held might be completely different to the returns being replicated (e.g. a European Equity ETF might actually hold Japanese government bonds with a total return swap to provide the performance of the European equities).
- For real estate the PPF would propose schemes use the Carbon Risk Real Estate Monitor tool (CRREM)[1] and engage regularly with their real estate managers to provide more granular data, as well as increasingly seek to access tenant data.
- Green bonds are a unique asset class that is widely seen as a meaningful tool to contribute to a greener future. However, there is a significant need within data providers and the market to differentiate between the green instruments and any associated benefits from holding them from the non-green capital of issuers. The PPF welcomes future development around the topic.
- Sovereign bonds are an increasing allocation for many DB schemes, however assessing the alignment of these instruments is not straightforward, especially in terms of an ITR metric, while engaging and influencing the alignment trajectory of any sovereign issuer is limited. This is even more apparent in emerging and frontier markets, where we actually need the transition and engagement to happen.

Considering all of the above, the PPF recommends calculating the portfolio alignment metric using a specific asset class methodology and presenting the results separately as per asset class. The PPF is also cautious about the feasibility of aggregating data from different asset managers, depending on the asset class and the methodology used. We would therefore recommend that it is acceptable for results to be presented not on aggregate level for the overall scheme's portfolio across different asset classes.

Q5. **Do you have any comments on the new regulatory burdens to business and benefits of requiring schemes to measure and report their Paris alignment?**

The PPF's own experience of the costs and time requirements associated with climate risk management are not insignificant. Adding portfolio alignment metrics will further increase the required budget and resourcing needs, especially given the complexity of these metrics, posing a potential burden for all schemes but particularly smaller schemes. From our experience with our portfolio alignment project we have been running throughout 2021, the time and people resources required in the period of data gathering and interpretation of the results are both

[1] For more information, see www.crrem.eu and www.crrem.org.

significant. Furthermore, the development of methodologies for estimation and/or creation of proxies in asset classes where not enough data is available often necessitates the support of external consultants. This links back to our response to Q2 around the need for sequencing these regulations with other parts of the market such as FCA regulated entities.

Q6. **Do you have**

(a) any comments on the impact of our proposals on protected groups and/or how any negative effects may be mitigated?

(b) any evidence on existing provision made by trustees in response to requests for information in alternative accessible formats?

(c) any other comments about any of our proposals?

We have nothing to add

Chapter 2 – Stewardship and the Implementation Statement

Q7. Should DWP include a vote reporting template in its implementation statement guidance which trustees are expected to use? If so, should such a template be based on the PLSA's vote reporting template? What changes, if any, would be needed to the PLSA template if it were to be adopted?

What are your views on the adoption of an engagement reporting template? Should it be separate from any vote reporting template or integrated with it, so that – in relation to equities – both voting and engagement activities are described for the same set of assets?

The PPF strongly believes that any additional reporting template should be aligned with PLSA vote reporting to reduce the overall reporting burden on schemes. However, the vote reporting template can be improved by:

- providing not only shares of the total meetings, but also total numbers
- requiring specific disclosures on shareholder resolutions and their categorisation between various topics/themes, especially in relation to climate change and social matters.

The PPF supports the adoption of an engagement reporting template that would cover the key highlights and major achievements. Engagement reporting has few defining characteristics that should be considered:

- Quantitative metrics should be reported on an annual or even a multi-annual basis, since some engagement efforts span out from months to years, and there should be efforts taken to avoid double counting
- Engagement reporting should be focused on the outcomes of the process or measuring real progress made, not just the process itself
- Any engagement reporting should also include qualitative description of the achievements to provide context

The PPF also suggests displaying specific engagement topics, for instance one focused on net zero alignment, and highlighting the process and progress of meaningful targeted engagement with companies, identified as most material in a portfolio.

Q8. Do you have any comments on our cross-cutting proposals for the draft Guidance on Statements of Investment Principles and Implementation Statements, in particular that:

(a) they are written for members?

(b) these are trustees' statements, not their consultants'?

(c) Implementation Statements should set out how the approach taken was in savers' interests?

(d) trustees should be able to include material from voluntary disclosures, such as Stewardship Code reporting, as long as they meet the requirements in the Regulations?

It should be noted that the PPF is a statutory corporation and not a conventional defined benefit occupational pension fund, therefore is not subject to the requirements of publishing an Implementation Statement (IS). Given this, we have no direct experience or observations on the practicality of the proposed Statutory Guidance, yet we wish to express our opinion on some aspects of the suggested guidance. This is primarily focused on the proposed non-statutory guidance in relation to the SIP.

As mentioned earlier, UK based schemes are already subject to a considerable amount of regulatory and non-regulatory reporting requirements. We are extremely supportive of flexible and coordinated measures that allow schemes to leverage the same material across multiple reporting requirements.

Q9. (a) Do you have any comments on our proposed Guidance on stewardship policies?

(b) Do you have any comments on our proposed Guidance on significant votes?

The PPF supports the guidance on defining a scheme's stewardship priorities, however we believe these should exist as an addendum to the stewardship policy or SIP, e.g. as a self-standing document. The inclusion of priorities in the SIP could be seen as too onerous and static, given the priorities are likely to change or be adapted more dynamically than the update of SIPs.

The PPF agrees with the necessity to report on significant votes cast and is supportive of the need for further clarity and guidance on the criteria to define a significant vote.

The PPF also believes that achieving credible net zero alignment will require the development of a net zero engagement plan that has well defined targets and thresholds. It should be noted that escalation through voting is a tool that is best employed when there is not enough meaningful progress or willingness to engage on climate priorities.

Q10. Do you have any comments on our proposed Statutory Guidance on the information to be included in the Implementation Statement with regard the requirements under the Disclosure Regulations, Schedule 3, paragraph 30(f)(i)-(iv)?

We have nothing to add

Q11. Do you have any comments on our proposed Statutory Guidance on meeting the Implementation Statement requirements in the Disclosure Regulations relating to choosing investments?

We have nothing to add

Q12. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to investment strategy?

We have nothing to add

Q13. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to financially material considerations (including ESG and climate change)?

The PPF suggests that including all of this information in the SIP is highly granular and makes the document contradict with the requirement to be accessible to various audiences.

The setting of baseline expectations of asset managers in tenders is a welcome practice and one that PPF has already employed through our use of PASS/FAIL minimum requirements.

The PPF agrees that schemes should more clearly define their net zero alignment ambitions and establish clear engagement plans for achieving them, as well as define mandates/performance objectives for asset managers to meet in line with achieving net zero.

Q14. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to non-financial matters?

We welcome the practice to consult on the views of members. However, inclusion of specific mechanisms relating to non-financial matters in the SIP maybe a limiting factor and could create additional confusion around the fact that trustees are not required to take account of non-financial matters.

Q15. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to arrangements with asset managers?

The PPF agrees that including stewardship considerations in the appointment and ongoing engagement with asset managers is sensible – and is already something the PPF is actively doing. We are also members of the occupational Pensions Stewardship Council and fully support the recommendation for asset managers to provide split voting or freedom for asset owners to express their voting preferences even in pooled funds.

Further information

The PPF would be happy to discuss the points we have made in our submission in more detail. Please contact Kristy Gaywood, Strategy and Policy Adviser, for general queries regarding the PPF (Kristy.gaywood@ppf.co.uk) or Claire Curtin, Head of ESG, for further information about our ESG strategy and RI reporting (Claire.curtin@ppf.co.uk).