CONSULTATION ON TAKING ACTION ON CLIMATE RISK: IMPROVING GOVERNANCE AND REPORTING BY OCCUPATIONAL PENSION SCHEMES

RESPONSE FROM THE PENSION PROTECTION FUND

OCTOBER 2020

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.

General comments

The Pension Protection Fund provides compensation to members of defined benefit (DB) schemes where their employer becomes insolvent and the pension scheme cannot secure benefits with an insurance company which are equal to, or more than, the PPF would pay. As at 31 March 2019 we had £32bn of assets under management and 250,000 members.

We are funded through a compulsory levy on eligible schemes, assets from pension schemes transferred to us, recovered assets secured from insolvent employers and the returns we make on our investments. Our investments are designed to match movements in our liabilities whilst also providing some outperformance.

Responsible investing and the integration of environmental, social and governance (ESG) factors have been embedded in our investment process since our inception. In 2018 we enhanced and formalised our RI framework. Since then, we have focused on applying the framework across both internally and externally-managed portfolios. As a UN-supported Principles for Responsible Investment (PRI) signatory and formal supporter of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD), we recognise the value in being clear about our RI

strategy and being transparent about what we are doing. This year we published our inaugural RI report to outline our approach and progress on our ESG priorities in further detail.

The PPF is supportive of the proposals put forward in this consultation and hopes that our experience thus far in assessing and reporting on climate-related risks will aid DWP's thinking on the proposed reporting and disclosure requirements as it evolves further.

Our comments are based on our experience as an asset owner with a commitment to responsible investment and our own transparent reporting. However, we are also interested in the proposals from a wider risk management perspective as we explore the risk of future claims on the PPF from the schemes we protect, and so have also sought to address that in our response. We are happy to discuss with DWP any of the points we make in our response below.

Risk management

The funding of the schemes we protect and the strength of their sponsors combine as a key risk for the PPF. While the risk is not within our control, by seeking a detailed understanding of it we can plan and prepare. Each year we compile and analyse data on the schemes we protect to give us an in-depth understanding of how the universe of schemes is changing. This helps us to model the level of claims the PPF may need to absorb in years to come, which combined with information about our membership will help to inform decisions on the future levy and investment strategy.

DB schemes with assets of over £1bn (in scope for this consultation) represent just over 70% of the universe of liabilities we protect. Whilst the proposals provide a welcome opportunity for trustees to start considering the implications that climate change risk may have for their pension scheme's funding, they do not provide any information that is easy to collate and use to understand the total level of exposure to climate change across all UK pension schemes, in particular the large DB schemes that the PPF protects. The lack of requirements for standardised quantitative metrics or disclosure of methodology approaches for these metrics is particularly relevant to us and the pension system as a whole. In addition, there do not appear to be any proposals to collate this information in the disclosures via the Pensions Regulator or another body.

Noting that climate change risk and reporting is an area where understanding is still in its infancy and there are a number of data challenges to meet , we would support more prescription to the approaches to be taken, possibly as part of the guidance, to help give more comparable information that can be aggregated across schemes. This could be developed in conjunction with the PRA approach to climate change for UK Banks and Insurers which would then help support the development of agreed standards and approaches by most large UK asset owners in the financial services industry.

Pension
Protection
Fund

PPF schemes in assessment

We are also considering the scope of the proposals and the impact that the application of these requirements may have on schemes which enter PPF assessment.

Schemes that are in a PPF assessment period (to establish whether they are sufficiently funded to pay members benefits at PPF levels of compensation) are included on our balance sheet, and there are legislative controls to prevent actions that could increase their protected liabilities. When a pension scheme enters the assessment period we work closely with the scheme trustees to help them better understand and mitigate their risks, where appropriate, to limit the risk exposure to the PPF.

We are exploring and considering in further detail the cost and benefit that these proposals would offer a scheme that enters PPF assessment in view of the fact that schemes are in assessment for a relatively short assessment window (usually under two years). Their assets then ultimately fall either within the PPF framework and investment strategies upon transfer to the PPF, or to an insurer if they exit assessment and buy out. We intend to report back to DWP on our views of the application to schemes in assessment outside of this consultation response.

<u>Consultation question responses</u>

Q3 . Subject to Government deciding to adopt any of the governance or reporting requirements proposed in this consultation, we propose to conduct a review in 2024 on whether to extend the measures to schemes with below £1bn in net assets which are not authorised master trusts or an authorised scheme offering collective money purchase benefits, and if so how and on what timescale. This review would be informed by consideration of TCFD disclosures by occupational pension schemes to -date, their impact, and the availability and quality of both free and paid -for tools and services. We would propose also to review any regulations and statutory guidance which had been put in place to identify whether any of this needs to be strengthened or updated. Do you agree with these proposals?

We would suggest that a first review of the measures and guidance is set prior to 2024 for a few reasons. Firstly, the availability of tools and methodologies for assessing climate-related risks is rapidly evolving and the industry is pushing for more standardisation, which could result in the guidance becoming outdated or inconsistent with best practice. In particular, we expect cross-industry standardisation to be driven by the PRA releasing climate change scenarios for Banks and Insurers in summer 2021.

Secondly, there is a risk that the pace of impacts arising from climate change (both transition and physical) escalates in a shorter timeframe than is anticipated today, which may lead to a sudden repricing of assets. This is a forecast that the PRI's Inevitable Policy Response is building out, which suggests that the repricing could happen as soon as 2024-2025. As the thinking on this progresses over the next couple of years, it could provide useful insights into how schemes can measure, report and improve their resilience by considering this within their asset allocation and portfolio construction sooner than 2024.

Pension Protection Fund

Thirdly, an interim review after the first phase of reporting in 2022 would allow for the opportunity to track progress and review learnings so far, as the issues/costs faced are likely to be similar for schemes in the £1bn+ and £5bn+ brackets. An interim review will also provide opportunity to share good practices and challenges from the marketplace with smaller schemes and help offset the cost of compliance which could be higher.

Q4 . We propose that regulations require trustees to:

a) **adopt and maintain oversight of climate risks and opportunities, and**
b) **establish and maintain processes by which trustees, on an ongoing basis, satisfy themselves that persons managing the scheme, are assessing and managing climate -related risks and opportunities. We also propose that regulations require trustees to describe:**
c) **the role of trustees in ensuring oversight of climate-related risks and opportunities; and**
d) **the role of those managing the scheme in assessing and managing climate-related risks and opportunities, only insofar as this relates to the scheme itself and the processes by which trustees satisfy themselves that this is being done. We propose that statutory guidance will cover the matters in the box above. Do you agree with these proposals?**

We agree with these proposals. It is important to note the need to integrate the climate change considerations in overall trustee duties and oversight so that these are not isolated, and will gradually become a vital part of consideration for all factors pertinent to a scheme's financial stability.

Q5. We propose that regulations require trustees to identify and disclose the climate change risks and opportunities relevant to their scheme over the short, medium and long term, and to assess and describe their impact on their investment and funding strategy. We propose statutory guidance will cover the matters outlined in the box above. Do you agree with these proposals?

We agree with these proposals, however we believe it might need to be further emphasised that the identification is plausibly only going to be "likely" climate change risks and opportunities and "likely" impact on investment strategy/funding strategy. We cannot know all of the risks and opportunities for certain as yet, and being more cautious in specifying these could also mitigate any potential legal risks.

The guidance might want to suggest a grading system (e.g. a ranking of low, medium, high impact) or some threshold, as it is unlikely that hard, definitive numbers can be produced with the current data availability and the multi-decade time horizon of climate change risks. Combining the likelihood and/or impact of the risk and a timeline (e.g. short, medium, long term) could provide trustees with an agenda for actionable prioritisation of risks and opportunities.

Q6. We propose that regulations require trustees to assess the resilience of their assets, liabilities and investment strategy and, in the case of DB, funding strategy, as far as they are able, in at least two climate-related scenarios, one of which must be a 2 °C or lower scenario and to disclose the results of this assessment. We propose statutory guidance will cover the matters outlined in the box above. Do you agree with these proposals?

We support these proposals, however we would suggest applying stronger encouragement to use three strategies – two to capture different transition risk scenarios (one for a more orderly transition, and one for a disorderly or “shock” transition) and one to capture a limited transition leading to greater physical risks as a result of much higher temperatures. The disorderly transition scenario could be particularly relevant for DB schemes that have a shorter funding horizon or are anticipating a buy-out situation within the next 10 years, as a sudden shock and repricing of assets (as suggested in the PRI’s Inevitable Policy Response and referred to in our response to question 3) could have a significant impact on the outcome of a buy-out.

Even for larger schemes with in-house resources dedicated to assessing climate risks and/or greater influence on encouraging asset managers to provide portfolio level reporting to them, there are challenges and limitations around performing scenario analysis. Based on our own experience in starting on this journey, these include:

- a current lack of availability of data beyond the listed equities asset class (especially in private market asset classes where “look-through” is rarely provided and portfolio companies/assets do not report anything);
- challenges around aggregating scenario outcomes up to the total portfolio (aggregating across various asset classes is currently almost impossible, due to the different approaches/methodologies used);
- a lack of tools that combine both transition risks and physical risks into one integrated assessment;
- considerable amounts of time, budgets and knowledge are required to either do the analysis in-house or outsource to an external agent (or a combination of the two) and then interpret the results – this is a substantial data management and analytical exercise in reality.

It is feasible that most schemes will only be able to assess and report on their listed equity allocation in the first instance, which may mean an insignificant percentage of their assets for those schemes with a low allocation to the asset class.

Further, we are supportive of giving trustees the flexibility to perform their own scenario analysis targeting a specific temperature gradient (2 °C or lower). But for the purposes of transparency and comparability, we believe that the parameters and assumptions of each scenario need to be disclosed – in line with the assessment results, since assumptions undertaken could differ materially from a scheme to scheme.

Pension Protection Fund

Risk management

In order for this information to be used by the PPF (and possibly the Pensions Regulator) to understand the risk of claims on the PPF, it would be helpful if at least some of the information presented for the scenario analysis was comparable across schemes. A temperature target range as currently included would only be of limited use for comparisons.

One way to do this could be to consider this as part of an early review designed to take account of the approaches and learning points from the PRA scenarios due to be released next year. Another approach would be to ask for significantly enhanced disclosure of the methodologies and assumptions used in the process.

It would also be helpful for schemes to disclose areas where a lack of data has meant that they need to make significant assumptions or they have not included asset classes within the analysis. This would be helpful in identifying cross industry data issues where additional DWP guidance may be useful.

Q7. We propose that regulations require trustees to:

a) adopt and maintain processes for identification, assessment and management of climate -related risks
b) Integrate the processes described in a) within the scheme's overall risk management.

We also propose the regulations require trustees to disclose:

c) the processes outlined in part a) above. We propose statutory guidance will cover the matters outlined in the box above.

Do you agree with these proposals?

A lot of the day-to-day management of climate-related risks occurs through stewardship activities (building on the heightened focus that the new UK Stewardship Code will bring). We would like to reiterate that this can be a substantial data management exercise that, if managed internally requires a multitude of platforms and look-through ability where possible; appointing data providers and/or visiting several open-source tools; and the ability to push asset managers to provide reporting on this. The type of mandate will have a big impact on this too – for example, investors in pooled funds are less likely to have look-through on the holdings or receive portfolio level reporting, and the engagement and voting activities lie with the manager not the asset owner, which can make it challenging for the investor to enact their requirements on specific issues.

Pension Protection Fund

Q8. We propose that regulations require trustees to:

a) **Select at least one GHG emissions -based metric and at least one non -emissions - based metric to assess the scheme's assets against climate -related risks and opportunities and review the selection on an ongoing basis;**
b) **Obtain the Scope 1, 2 and 3 GHG emissions of the portfolio, and other non - emissions -based data, as far as they are able;**
c) **Calculate and disclose metrics (including at least one emissions -based metric and at least one non -emissions -based metric) used to quantify the effects of climate change on the scheme and assess climate -related risks and opportunities. We also propose in regulations that trustees be required to disclose:**
d) **Why the emissions data that is estimated does not cover all asset classes, if this is the case.**

We propose that trustees will not be mandated to use a specific measure to assess the effects of climate change on the scheme's portfolio. We propose statutory guidance will cover the matters outlined in the box above.

Do you agree with these proposals?

We are supportive of climate-related reporting across the investment chain, from corporates to asset managers to asset owners. However, as mentioned in our response to Question 6, data limitations, access to data/look-through capabilities and differences in methodologies all pose some considerable challenges to schemes in calculating these metrics, especially if they are looking to aggregate across different portfolios or assets. Thus we would recommend that the statutory guidance provides some clarity and flexibility on the asset classes to be covered at first and suggests that schemes could establish a plan for rolling this out over time to increase the level of disclosure across the fund step-by-step.

We would like to note that currently it is near-impossible to aggregate carbon emissions up across different asset classes to one overall figure. In addition, a gap exists between carrying out bottom-up scenario analysis on portfolio companies and top-down scenario analysis on macro-economic factors that cannot currently be fully aligned.

Furthermore, we believe that trustees should not to be required to disclose the "implied temperature rise" (ITR) of their portfolios immediately, for the same reasons of data limitations and significant variations in the underlying assumptions made in scenario analyses.

We would welcome further guidance on what is meant by non-emissions based metrics, as we did not feel this was sufficiently clear from the proposal documents.

Q9. We propose that regulations require trustees to:

a) **set at least one target to manage climate -related risks for one of the metrics trustees have chosen to calculate, and to disclose those targets(s).**

b) **calculate performance against those targets as far as trustees are able and disclose that performance. We propose statutory guidance will cover the matters outlined in the box above.**

Do you agree with these proposals?

We are supportive of the proposal's requirements for schemes to disclose climate-related metrics. However, we would have concerns about legislative requirements to set and disclose targets from day one, as we think a level of sequencing is needed for this to be meaningful and measured. The TCFD Task Force's own view is that implementation of its recommendations is a journey and organisations are in different places in terms of their exposure to climate-related risks and opportunities and their reporting capabilities. We therefore believe that it is important to first establish robust and decision-useful reporting, and then take the time to consider and discuss what these outputs mean, to enable a determination of what the most appropriate and relevant targets are for the scheme.

Given that there is still very little homogeneity and asset-level coverage within emissions-based metrics at a scheme level, it would be more practical for a scheme to start with setting aspirations on a governance-related metric (e.g. x% of portfolio covered by disclosure, number of external managers reporting on climate).

If an emissions-based metric should be required, we believe it would be important to emphasise that setting a target around this should not mean that trustees will have to divest from higher-carbon investments (nor that it is expected). We believe that targeted stewardship with high-carbon emitters and holding them accountable to transitioning their strategy could be more beneficial than divestment. However, rigorous measurement of their progress and performance should be in place and the ultimate recourse of potential divestment where feasible, in order to avoid the risk of green washing.

Q 10. We propose that, for all schemes in scope:

a) **The trustees should be required to publish their TCFD report in full on a publicly available website where the report is accessible free of charge.**
b) **The trustees should be required to include in the Annual Report and Accounts a website link to the location where the full TCFD report may be accessed in full.**
c) **The trustees must notify all members to whom they must send the annual benefit statement of the website address where they can locate the full TCFD report – this must be set out in the annual benefit statement.**
d) **The trustees should be required to report the location of their published TCFD report to the Regulator by including the corresponding website address in their scheme return.**
e) **The trustees should also be required to report the location of their published Statement of Investment Principles ("SIP"), Implementation Statement and excerpts of the Chair's Statement by including the corresponding website address or addresses in their scheme return.**

Pension Protection Fund

Do you agree with these proposals? Is there a better way to notify members of where to find this information?

For example, for DB schemes, might the summary funding statement required by regulation 15 of the Disclosure Regulations be a more appropriate way to signpost members to this information?

We believe that taking the TCFD's recommendations on board means that there should be a discussion and evaluation of climate-related risks and opportunities within a scheme's financial report and accounts. We would suggest that b) above is expanded to recommend this also, rather than just a link to the TCFD report. Otherwise, it is in danger of being assumed to be non-financial.

Risk management

Beyond the Pensions Regulator checking that the report has been produced, it is not clear what level of analysis or consideration of the TCFD reports will take place. It would be helpful to set out the Pensions Regulator's role in these requirements more clearly. In particular, how they may support schemes who find it difficult to comply with this guidance and collate information.

DWP and the Regulator could also consider whether there are any other documents / duties undertaken by Trustees where consideration of climate risk would be helpful, such as the triannual valuation and scheme recovery plans. Incorporating the assessment of climate risk exposure in to core reporting documents could help to embed scheme thinking and planning on climate risk and RI.

As mentioned previously, if comparable quantitative metrics are required to be produced, either now or in the future, it would be helpful if they were uploaded on to a central system (such as the Pensions Regulator's exchange system).

Q 12: Do you have any comments on the new regulatory burdens to business and benefits, and wider non -monetised impacts we have estimated and discussed in the draft impact assessment?

The costs and time estimates for performing climate-related analysis seem very low, based on our practical experience over the last year or two. We are happy to engage further with DWP to share these experiences and our assessments of costs off-line.

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 (including questions on risk management or schemes in assessment (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).