100 HYMANS # ROBERTSON

Sixty second summary

Government response to consultation on TFCD Regulations for pension schemes

The DWP has published its final regulations and related statutory guidance on mandatory TCFD governance and reporting for occupational pension schemes alongside a response to their second consultation. There are limited changes to the broad regulatory requirements with the changes made providing simplification or clarification of the policy intent.

As noted within the consultation response, these measures will see the UK become the first G7 country in which trustees of pension schemes are required by regulations to consider, assess and report on the financial risks of climate change within their portfolios. These regulations sit within the wider context of the UK Government writing the world's most ambitious climate change target into law, with the goal of reducing emissions by 78% of 1990 levels by 2035, and also form part of the Government's private finance strategy ahead of COP26 to be held in Glasgow in November 2021. The Government has also announced its expectation that TCFD-aligned disclosures will become mandatory across the economy by 2025. A significant proportion of these requirements are expected to be in place by 2023.

With the DWP now set to legislate this Summer, trustees, particularly those of schemes within the first wave of reporting, are expected to focus on implementing these measures. Having a clear plan for action is imperative. Experience already suggests that building a clear understanding is critical and that a focus on key decisions, at least during the first year of TCFD governance and reporting, will allow a smoother path to implementation.

What changed as a result of the second consultation?

Many of the changes provided either clarification or simplification which we welcome. These changes are as follows:

- The definition of bulk annuity contracts has been clarified in that it does not, for example, require exact matching to benefit payments. Annuity contracts are excluded from the calculation of assets for determining whether or not a scheme is subject to the regulations, but should be included in scenario analysis;
- Where requirements only apply for part of a scheme year, reporting only needs to cover that part of the scheme year;
- Expectations around education have been clarified – trustees need to have sufficient knowledge and understanding to assess both opportunities and risk.
- Trustees need to have processes in place to ensure that persons undertaking governance activity for the scheme take adequate steps to identify, assess and manage climate related risks and opportunities. They must also ensure that processes in place are integrated into their overall risk management of the scheme;
- Scenario analysis must be undertaken in the first year the regulations apply, but can be undertaken before the date that the regulations apply – the same applies to the calculation of metrics. Once undertaken, scenario analysis must be repeated at least every three years.
- Scope 3 emissions data does not need to be collected in the first year of the requirements, but applies from the second year onwards; and
- Target setting must take place during the first year that the regulations apply, not at the start of the period, and performance must be measured within each scheme year.

The final requirements, including these changes, have been set out at the end of this note

Also worth noting…

"As far as they are able"

The response and accompanying guidance also provides further detail on that which trustees must carry out 'as far as they are able'. These actions are: scenario analysis, obtaining data, calculating and using metrics and measuring performance against trustee-set targets. 'As far as they are able' has been clarified as 'taking all such steps as are reasonable and proportionate taking into account the costs incurred by scheme and the time required to be spent by the trustees or people acting on their behalf'. This appears to be a tougher line than was previously expected and comes across as more of a "comply or explain" basis. This is likely intentional as a way of utilising trustees and schemes to push forward asset managers and investees into compliance on climate plans, particularly given the Government's ambitious aims.

Chosen scenarios

As outlined in the table overleaf, trustees must conduct scenario analysis for at least two scenarios. In selecting the scenarios, the guidance notes that trustees should consider not only the projected potential global average temperature rise but also the nature of the transition to that temperature rise. What this means is that there are a number of different scenarios representing an eventual global average temperature rise of 2°C above pre-industrial levels due to differences in the assumptions made about the *type* of transition. The guidance specifically calls out a paper by the Network for Greening the Financial System that sets out representative scenarios which trustees may want to consider. Finally, it's worth noting that whilst the scenario analysis element of TCFD may be seen as one of the trickier aspects that trustees must undertake, it should come as some comfort that putting it into practice, on the liability side at least, will be similar to scenario analysis that trustees have been undertaking for years now.

What next?

Trustees should note the final regulatory requirements and begin to take steps to implement these additional governance requirements. For those trustees who have not taken steps to do so, education remains a critical first step and we will be running a webinar for trustees during July 2021. It is crucial that those subject to the first wave of requirements have a plan to deliver the governance requirements by no later than 1 October 2021.

The TCFD itself has recently published a new consultation on updated recommendations, with a particular focus on metrics. The DWP have confirmed that they will monitor that work and continue to engage with pension schemes to ensure that the Regulations and Statutory Guidance remain appropriate and do not require further amendments. In any event, the DWP has undertaken to review these regulations in 2023.

LGPS funds are not yet subject to TCFD governance and reporting requirements but we expect the Ministry for Housing, Communities and Local Government to publish their consultation on this subject in the near future. The shape of the requirements for LGPS funds is likely to be heavily informed by the regulations established by the DWP and LGPS funds may therefore consider following a similar plan.

Should you have any questions, please contact your usual Hymans consultant.

Simon Jones
Head of Responsible Investment

simon.jones@hymans.co.uk

Amy Sutherland
Climate change consultant

amy.sutherland@hymans.co.uk

What do the final requirements look like?

The substance of draft regulations has been largely retained. Areas of change are highlighted in bold:

TCFD area	Requirements
Scope and timing	• Applies to schemes with assets over £5bn at 1 March 2020 and Master Trusts from 1 October 2021 and to schemes with assets over £1bn at 1 Mach 2021 from 1 October 2022. Insurance contracts are excluded from assets for this purpose.
Governance	• Establish and maintain oversight of climate related risks and opportunities by no later than 1 October 2021 (schemes >£5bn and Master Trusts) or 1 October 2022 (schemes >£1bn). • Establish and maintain processes that allow the trustees to satisfy themselves that those managing the scheme are assessing and managing climate related risks and opportunities. "Those managing the scheme" means those who undertake governance activities in relation to the scheme and those who advise or assist the trustees with respect to governance activities, excluding legal advisers. • Trustees who are subject to the requirements must have knowledge and understanding of the principles relating to the identification, assessment and management of risks to occupational pension schemes arising from the effects of climate change.
Strategy	• Identify climate related risks and opportunities that will impact the investment and, for DB schemes, funding strategy of the scheme over different time horizons. The chosen time horizons must be disclosed. • Assess the impact of identified risks and opportunities on the scheme's investment and, for DB schemes, funding strategy. • Trustees will not be required to describe in their disclosures the climate-related risks and opportunities relevant to the scheme which are identified by persons other than the trustees.
Scenario analysis (a subsection of Strategy)	• Scenario analysis must be undertaken to assess the resilience of the scheme's assets, liabilities and investment and, for DB schemes, funding strategy to climate related risks in at least two scenarios (including one scenario that reflects an annual temperature rise of 1.5 to 2 degrees Celsius). • Undertake scenario analysis in the first year, **which may be undertaken during the scheme year ahead of the scheme being subject to the requirements**, and at least every three years thereafter. In other years trustees must review whether or not circumstances are such that they should refresh their analysis; or, if they decide not to, explain why. **Whenever trustees undertake fresh scenario analysis the triennial cycle is automatically re-set.**
Risk management	• Adopt and maintain processes for identifying, assessing and managing climate-related risks. • Ensure the integration of climate-related risks into overall risk management processes of the scheme
Metrics (a subsection of Metrics and Targets)	• Trustees must select a minimum of two emissions-based metrics, one of which must be an absolute measure of emissions and one which must be an intensity-based measure of emissions. Trustees must also select one additional climate change metric to calculate in respect of the scheme's assets. • Trustees must obtain the scope 1, 2 and 3 greenhouse gas emissions and other data relevant to their chosen metrics and use this data to calculate their selected metrics. **Trustees will not have to collect and report on Scope 3 emissions in the first year they are subject to the requirements.** • Trustees must use the metrics they have calculated to identify and assess the climate-related risks and opportunities which are relevant to the scheme. • Trustees will be required, as far as they are able, to obtain the data required to calculate their chosen metrics on an annual basis.
Targets (a subsection of Metrics and Targets)	• Trustees must set a non-binding target for the scheme in relation to at least one of the metrics which they have selected to calculate. **Target setting should take place during the first scheme year for which the Regulations apply rather than on the first day on which the Regulations apply.** • On an annual basis (i.e. each scheme year) trustees must measure performance against the target and, taking into account the scheme's performance, they must decide whether to retain or replace the target. Where trustees elect to replace the target, a new target must be set.