NORTON ROSE FULBRIGHT

UK Pensions Briefing: Climate change governance and reporting requirements for pension scheme trustees

March 2021

Introduction

The Department for Work and Pensions (DWP) has issued its response to last year's consultation about mandatory climate risk governance and reporting by occupational pension schemes. It has now launched a second consultation, this time on the detailed legislation and statutory guidance that would implement the government's policy.

The consultation closes on March 10, 2021 and the new laws are expected to come into force in October this year.

These new obligations build on but are distinct from the environmental, social and governance (ESG) requirements imposed on trustees in recent years (which require disclosure of trustees' investment policies regarding climate change) and are much more directive in terms of the steps trustees need to take to tackle climate risk.

Schemes that are caught by the new requirements have a lot of work to do, some urgently, to put in place the new governance processes and report against them.

What are the new requirements?

The draft regulations and statutory guidance require trustees to assess and report on the climate change risks and opportunities in their investment portfolio. Specifically the DWP proposes that trustees will be required to take the following steps:

- **Disclosure:** Make climate change disclosures in line with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) in an annual TCFD report.
- **Governance:** Have oversight of climate-related risks and opportunities which are relevant to the scheme and report (in their TCFD report) on how they are achieving this.
- **Inform members:** Publish the TCFD report on a publicly available website free of charge and tell members where they can locate it, by signposting it in the scheme's annual report, annual benefit statements and annual funding statement.
- **Strategy:** Identify and assess the impact of climate-related risks and opportunities on the scheme's investment and (for defined benefit schemes) funding strategy over the short-, medium- and long-term.
- **Scenario analysis:** Conduct scenario analysis to test the impact of climate change on the scheme's assets and liabilities and the resilience of the scheme's investment and funding strategies. This needs to be done in the first year and then at least every three years.

- **Risk management:** Have processes for identifying, assessing and effectively managing climate-related risks which are relevant to the scheme, which are integrated into the scheme's overall risk management.
- **Metrics:** Select and calculate climate-change metrics in respect of the scheme's assets, including emissions metrics (e.g. total emissions and carbon footprint metrics).
- **Targets:** Set a non-binding target for the scheme in relation to at least one of the selected metrics and measure performance against it annually.
- **Trustee knowledge and understanding:** Have the appropriate degree of knowledge and understanding of climate change risks and opportunities to be able to properly exercise their functions.

To whom will the new requirements apply?

For now it is envisaged that they will apply to trustees of:

- Large trust-based schemes – both defined benefit and defined contribution – with assets of £1 billion or more,
- All authorised master trusts, and
- All authorised collective money purchase (CMP) schemes.

The new requirements will be introduced as a phased roll-out, starting with the largest pension schemes, master trusts and CMP schemes (see below).

Currently no decision has been made about when these requirements will apply to schemes with assets under £1 billion, but DWP will review this in 2023 with a view to potentially extending them to smaller schemes from late 2024 or early 2025. In the meantime the Government encourages out of scope schemes to comply on a voluntary basis.

The FCA plans to consult on TCFD reporting rules for contract-based pension schemes (and asset managers) in the first half of 2021 with a view to bringing the requirements into force in 2022.

When will trust-based schemes have to comply?

Schemes that have at least £5 billion of assets or more at the end of their first scheme year that ends on or after March 1, 2020 will have to comply with the new governance requirements from October 1, 2021 (or, if later, the date they obtain audited accounts). All authorised master trusts will have to comply from October 1, 2021.

Schemes with at least £1 billion of assets at the end of their first scheme year that ends on or after March 1, 2021 will have to meet the new governance requirements from October 1, 2022 (or from the later audited accounts date).

Bulk and individual annuity contracts – where the trustee does not have control over the investment of assets – will not count towards the asset threshold for these purposes.

Schemes that have to comply will have seven months from the end of the scheme year to produce a TCFD report. Schemes can fall out of scope if their assets fall below £500 million or they stop being authorised.

What are the sanctions for non-compliance?

Financial penalties will apply where the regulations are breached of up to £5,000 for individual trustees and up to £50,000 for corporate trustees. The Regulator must impose a penalty of at least £2,500 if no TCFD report is published on a website. The Regulator will also be able to issue improvement notices, including in relation to trustee knowledge and understanding.

What does this mean for Trustees?

Project planning

The consultation acknowledges that, particularly for the larger schemes and authorised master trusts, timings will be tight. For many schemes a great deal of work lies ahead to put adequate governance structures in place to report against.

Trustees should speak to their advisers to understand whether and when these requirements will start to apply to their scheme. They may find it helpful to draw up a project plan to work out what steps they need to take and when, to ensure they meet their governance and reporting deadlines.

A proportionate approach

The DWP recognises that climate-change risk assessment and reporting is an evolving area and much of the data trustees need simply will not be available yet, or cannot be obtained without disproportionate cost and effort. Several of the new activities therefore only need to be performed by the trustees "as far as they are able".

This means taking *"all such steps as are reasonable and proportionate in the particular circumstances"* taking into account the costs which will be incurred by the scheme and the time required to be spent by the trustee or people acting on their behalf.

This express permission to take a proportionate approach may go some way to reassuring trustees who are concerned about the potential for resources to be diverted from other necessary scheme work.

However, trustees are unlikely to be let off the hook easily where there are important data gaps. The DWP expects trustees to target their resources sensibly at the firms most likely to contribute materially to climate-related risks for their scheme. Modelling or estimation may be needed where data is incomplete and gaps will need to be explained.

Trustee knowledge and understanding

The Government acknowledges that this will be a steep learning curve for many trustees and many will be feeling daunted by the task ahead. The proposed statutory requirement for affected trustees to have knowledge and understanding of these issues would apply to both individual trustees and directors of trustee companies. It will not be enough for the board as a whole to understand these matters.

This does not mean trustees need to master the technical detail. The draft guidance is clear that trustees can engage experts to carry out the required activities on their behalf, but trustees and trustee directors will retain overall responsibility and *"should have sufficient knowledge and understanding to interpret the results of any analysis and the know how to take action in light of these results, or indeed to challenge assumptions, external advice and information."*

Trustees should consider attending appropriate training to ensure they can meet the required standard. They should also expect climate change to become a feature of the trustee's routine business. The DWP expects that *"for most schemes, trustees will require regular discussion of climate-related risk and opportunities at board level, as a substantive agenda item."*

Adviser agreements

Where trustees will need advisers to help them meet the requirements, they may wish to update relevant adviser agreements and strategic objectives to set out the responsibilities clearly.

What's next?

The Government is keen to press ahead with its plans to make UK-regulated organisations subject to climate-change obligations by 2025. Rules are already in force for UK-listed companies with accounting periods on or after January 1, 2021. TCFD reporting requirements for asset managers in 2022 should further help pension schemes to obtain the good quality data they need for their own disclosures and governance.

While the DWP recognises that the time-scales for some pension schemes are ambitious, the message is that the Government's policy is largely settled, trustees have had adequate notice of it, and schemes (particularly those in the first wave) should now get on with the work they need to do.

Contacts

Lesley Browning
Partner
Tel +44 20 7444 2448
lesley.browning@nortonrosefulbright.com

Shane O'Reilly
Partner
Tel +44 20 7444 3895
shane.o'reilly@nortonrosefulbright.com

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