XPS Pensions Group

XPS Insights
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Government ramps up focus on climate change for pension schemes

What you **need to know**

- Pension schemes are increasingly in scope of regulatory focus on climate change. Most recently, the Department for Work and Pensions (DWP) has been consulting on new requirements for large pension schemes to assess, measure, manage and report on climate-related risks.
- Under the proposals, schemes with assets over £5bn, authorised defined contribution (DC) master trusts and collective DC schemes will be subject to new rules from October 2021. Schemes with assets over £1bn will be in scope from October 2022. Schemes in scope must publish an annual report on their climate risk on a public website, timed to coincide with scheme accounts. The Government will review if and how to include smaller schemes in 2024.
- The Pension Schemes Bill 2019-21 paves the way for regulations to put the above in place. Statutory guidance to accompany the regulations will also be consulted upon.
- In addition, the Pensions Climate Risk Industry Group (PCRIG) published draft non-statutory guidance for trustees in early 2020 on managing climate risk, with final guidance due in late 2020.
- Recently, The Pensions Regulator (TPR) has urged all schemes to 'build capacity' on climate risk management, and now includes questions on climate risk when engaging on risk management.

Actions you can take

- **Carry out trustee training** to understand developing requirements on managing climate risk.
- **Understand the impact** of the forthcoming regulations, when you will be affected and what is required.
- **Review options available to integrate climate risks** into your risk management plans.
- **Speak to your investment adviser** on how this ties in with your Environmental, Social and Governance risk management strategy.

The **types** of climate risks:

Type of risk	What is it?	How does it impact pension schemes?
Physical risk	Uncontrolled climate change, e.g. extreme weather events, sea level rises and flooding, and land use change	Disruption to businesses, land use change and destruction of property all harm the global economy, leading to falls in asset values and lower investment return outlooks, impacting funding. Sponsor covenants may be affected too.
Transition risk	The impact of policy and behavioural changes on sectors and companies from the transition to a low carbon economy	Higher energy pricing and regulatory costs will impact business profits and lead to changes in market sentiment. This in turn leads to asset repricing, impacting both individual stock prices as well as whole sectors and markets.
Legal risk	The risk of litigation, including class actions, for organisations that fail to address climate risks	Large pension schemes may see direct legal action from 'pressure'/member groups. Sponsors that fail to take action on climate risk could also face legal action and costs.

Source: Physical and transition risks are described by TCFD. Legal risk reflects opinion from some legal firms.

The finer detail: DWP climate proposals

What schemes will be required to do under the DWP proposals	
Governance	Put processes in place to integrate climate risk management into the scheme's ongoing governance, and ensure oversight of any parties that climate risk management is delegated to (for example asset managers).
Strategy	Identify the climate risks that are expected to have the most impact on the scheme's strategy, and assess the impact of these risks. Assess the resilience of the scheme's strategy to climate risks by conducting scenario analysis.
Risk management	Put in place processes for identifying, assessing and managing climate risks, and integrate these into the scheme's overall risk management framework.
Metrics and targets	Select at least one emissions-based metric and one non-emissions based metric to assess the scheme's asset portfolio against, and collect data on and calculate these on a regular basis. Set at least one target for one of the chosen metrics and calculate performance against this on a regular basis.
Reporting	Publish an annual report on the four areas above, including the results of scenario analysis, the chosen portfolio metrics and performance against targets. Reports must be made publicly available on a website.

A short summary of recent action on climate change	
Paris Agreement and UK Government legislation	In **2016**, 196 countries signed the Paris Agreement to limit climate change to 2C above pre-industrial levels. The UK Government has subsequently enacted legislation in 2019 to achieve net zero greenhouse gas emissions by 2050 which requires co-ordinated action across the whole economy.
Task Force on Climate-related Financial Disclosures (TCFD)	In **June 2017** the international Financial Stability Board's TCFD published its final report, setting out 11 recommendations for organisations to assess, measure, manage and report on climate-related risks and opportunities. DWP's requirements for pension schemes are based on the TCFD recommendations. The UK Government intends to mandate TCFD reporting across the economy by 2025.
Investment and Disclosure Regulations	From **October 2019**, regulations require trustees to set a policy on environmental, social and governance factors, including climate change, to disclose this in their investment principles, and, from October 2020, publish a report on implementation.
Green Finance Strategy	In **July 2019** the Government's Green Finance Strategy set plans for the finance industry to support the UK's 2050 net zero target. UK financial regulators including TPR issued a joint statement confirming their commitment to this strategy.
Pensions Climate Risk Industry Group (PCRIG)	In **summer 2019** the PCRIG was established and in early 2020 it set out draft guidance for pension schemes in respect of climate risk. The Pensions Minister has stated his intention to put the guidance on a statutory footing.
Recent statements from government worth noting to understand UK direction	**Guy Opperman**, Minister for Pensions and Financial Inclusion, stated in the DWP consultation "There are real financial risks resulting from climate change... Trustees who do not consider these matters will be breaching their statutory duties.". On 9 November 2020 **Rishi Sunak,** UK Chancellor, confirmed the Government's ambition to make TCFD-aligned disclosures mandatory with 42% of pension schemes (by assets) to be covered in 2021 and 72% in 2022.

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