EVERSHEDS SUTHERLAND

Guiding you through the complexities

Guide to the Pension Schemes Act 2021:
Climate change

Practical solutions for trustees and sponsors

October 2021

What we cover

This guide looks at the key changes that the Pension Schemes Act 2021 introduces and the new obligations that it will impose on trustees and sponsors. In each section, we look at what the new legislation requires and then set out some practical steps that trustees and sponsors should be considering now.

The Act became law on 11 February 2021 and the provisions are gradually being brought into force, with most of the key criminal offences and sanctions having come into force on 1 October 2021. Additional detail in relation to most areas has been provided in regulations, draft regulations and statutory guidance. However, there are still some areas, such as the new funding requirements and the dashboards, where more information is required and draft regulations have yet to be issued.

We have updated this guide to take account of the detail which is already available to help trustees and sponsors see what's coming over the horizon and understand what they will need to do to comply with the new requirements. We plan to update this guide regularly as further regulations and statutory guidance are issued.

Click to access our Pension Schemes Act 2021 guides to criminal offences; Pensions Regulator new powers; scheme funding; transfers; dashboards; climate change; and collective money purchase schemes.

If you need any further help, please ask your usual Eversheds Sutherland pensions contact, or speak to one of the team listed at the back of this guide.

***Note**: This guide is intended to provide an overview of the issues covered only. It is not intended to provide legal advice and cannot be relied upon. Trustees and employers who have any concerns about the issues raised should seek their own legal advice.*

Climate change

The Act sets out requirements for pension scheme trustees to assess, manage and report on climate-related risks in line with the recommendations of the taskforce on climate-related financial disclosures (TCFD).

The requirements are currently only aimed at larger schemes and are being phased in from 1 October 2021. However, the government has said it will review the application of the requirements to smaller schemes in the second half of 2023.

The Regulator has been clear that all schemes should be addressing climate change, whether or not they are caught by the new regime. It said in a blog post: "*A scheme that does not consider climate change is ignoring a major risk to pension savings and missing out on potential investment opportunities*" and separately advised trustees to build capacity in this area.

Regulations and statutory guidance have been issued. In addition, non-statutory guidance has been issued by the Pensions Climate Risk Industry Group (set up by the DWP, the Pensions Regulator and other pension representatives). The Pensions Regulator has also issued draft guidance on climate change.

Schemes in scope

The requirements are currently aimed only at larger occupational and commercial schemes and are being phased in over a 12 month period. It is therefore key to understand which schemes are in scope and when:

- schemes with net assets exceeding £5bn at the scheme year ending on or after 1 March 2020, authorised master trusts and authorised collective money purchase schemes will need to comply from 1 October 2021, with the first TCFD report due within 7 months of next scheme year-end
- schemes with net assets between £5bn and £1bn at the scheme year ending on or after 1 March 2021 will need to comply from 1 October 2022, with the first TCFD report due within 7 months of the next scheme year-end
- where asset values fall, there are provisions for schemes to cease to be in scope (depending on how much the drop in value is)

Basic requirements in the Act

The Act provides for in-scope schemes to be required to implement a new set of governance requirements around climate change which covers:

- reviewing the scheme's exposure to certain risks
- assessing certain types of assets held by the scheme (and determining their contribution to climate change)
- determining, reviewing and (if necessary) revising a strategy and/or targets for managing exposure to certain risks
- measuring performance against such targets and against the goals in international climate change agreements
- preparing additional documents and publishing information relating to the effects of climate change on their scheme

Details in regulations and statutory guidance

The regulations and statutory guidance set out more detail around these requirements. Trustees of in-scope schemes will need to address the following areas:

- Governance: establish and maintain oversight of climate-related risks and opportunities. They must have processes to ensure that those undertaking governance on their behalf or who advise or assist them with respect to governance, are properly dealing with climate change issues.
- Strategy: identify and assess the impact of climate-related risks and opportunities which have an effect over the short, medium and long term (determined by the trustees) on the investment strategy and (where relevant) the funding strategy. This will include additional scrutiny of the employer's covenant.
- Scenario analysis: as far as they are able, undertake scenario analysis assessing the impact of climate change on the scheme for at least two scenarios - one of which corresponds to a global average temperature rise of between 1.5 and 2°C on pre-industrial levels. This must be done in the first year the new requirements apply and then every three years, with consideration being given to the need for a new analysis in intervening years. Underlying data must be obtained annually.
- Risk management: establish and maintain processes for identifying, assessing and effectively managing climate-related risks which are relevant to the scheme.
- Metrics: select and, as far as they are able, calculate an absolute emissions metric, an emissions intensity metric and one additional climate change metric.
- Targets: set a non-binding target in relation to at least one of the selected metrics. On an annual basis, they must measure performance against the target (as far as they are able) and, taking into account the scheme's performance, they must decide whether to retain or replace the target.
- Trustee knowledge and understanding: ensure they have the appropriate degree of knowledge and understanding of the principles relating to the identification, assessment and management of climate change risks and opportunities in respect of occupational pension schemes, to enable them to properly exercise their functions. In-scope trustees will therefore need to consider whether they need additional training.
- TCFD report and disclosure: publish an annual TCFD report disclosing how the scheme complies with the TCFD's recommendations and make it freely available on a website. In-scope trustees will be required to provide details of where the report can be found online in the scheme's annual report and accounts, annual funding statement (for DB schemes) and annual benefit statements (for cash balance and/or DC benefits). The annual funding statement and annual benefit statements will also need to confirm when the report will be provided on request in hard copy.

In addition, in a consultation paper issued in October 2021, the Government proposed requiring in-scope schemes to calculate and disclose a portfolio alignment metric setting out the extent to which their investments are aligned with the goal of limiting the increase in the global average temperature to 1.5 degrees Celsius above pre-industrial levels. It is intended that this new requirement will come into force on 1 October 2022.

The Regulator will be able to impose penalties and issue compliance notices if trustees have failed to comply with the new governance and disclosure rules. These can also be issued against third parties where the Regulator considers that they are responsible for a failure.

The existing disclosure penalty regime will apply where trustees fail to inform members where they can find the TCFD report. The Regulator **must** impose penalties of at least £2,500 if a trustee fails to publish a TCFD report on a publicly available website. The Regulator has issued a draft update to its monetary penalties policy setting out how it intends to impose penalties in relation to breaches of the climate change regime and what it will expect in relation to the requirements that apply "*as far as [trustees] are able*". In addition, the reputational risks associated with non-compliance are likely to increase over time. These will be just as much an issue for employers as trustees since the scheme will often carry the employer's brand, and may tarnish the employer's own efforts in this area.

Practical implications of changes

Governance

Trustees may need to put in place new governance structures to identify and continuously monitor climate change risk in order to comply with the new regulations and guidance. These could include delegating oversight to an appropriate working group with suitable terms of reference, establishing reporting lines from investment managers, and agreeing the metrics to be used.

Action plan

Trustees of larger schemes should consider formulating an action plan for how they will comply with the new disclosure requirements and to determine whether any additional training is needed.

Obtaining information

Trustees may need to obtain further information from their asset managers and investment consultants in order to comply with the new regime and may want to talk to them now to establish the extent of information available, how that information will be provided and any material data gaps. Trustees will also need to discuss which metrics are available.

Investment strategy

Trustees may need to review their investment strategy to ensure it adequately addresses climate change risks and opportunities. Even where a scheme is not within the scope of the new rules, environmental, social and governance issues (including climate change) still need to be addressed in the statement of investment principles.

Covenant review

Trustees should consider incorporating climate scenario analysis into covenant review process and engage with the employer to ensure adequate access to information and appropriate processes for identifying and handling confidential information.

Timing

In-scope trustees should ideally ensure that their compliance measures are in place by the start of the scheme year in which their 1 October effective date falls – otherwise they will be reporting on only part of a year. This also ensures some leeway ahead of the hard compliance date.

Regulator

The Regulator regards climate change as important, so watch out for more statements from it about its expectations around what trustees should be doing in this area and the final version of its climate change guidance.

Risk management

Trustees should take a proportionate and risk-based approach to assessing climate-related risks by focussing on the most material risks, integrating these risks into the overall risk management framework and recording their processes for identifying and assessing these risks.

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