CONSULTATION RESPONSE

DEPARTMENT FOR WORK AND PENSIONS (DWP)

CLIMATE AND INVESTMENT REPORTING: SETTING EXPECTATIONS AND EMPOWERING SAVERS

January 2022

ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 4,500 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles with approximately US$121 trillion in assets under management.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that environmental, social and governance (ESG) factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

ABOUT THIS CONSULTATION

This consultation was issued by the UK Government's Department of Work and Pensions in October 2021. It comprises two distinct chapters Chapter 1 – Measuring and reporting Paris alignment, and Chapter 2 – Stewardship and the Implementation Statement.

The first chapter seeks views on policy proposals to require trustees of larger occupational pension schemes, authorised master trusts and authorised schemes providing collective money purchase benefits to measure and report on the Paris alignment of their investment portfolios. It is proposed that the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 are amended to require trustees subject to those Regulations to calculate and disclose a portfolio alignment metric describing 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. This document therefore also consults on the draft Occupational Pension Schemes (Climate Change Governance and Reporting) (Amendment, Modification and Transitional Provision) Regulations 2022, and draft amendments to statutory guidance.

The second chapter of the consultation seeks to address deficiencies in scheme governance in relation to stewardship and voting by proposing new draft guidance which sets out stewardship and ESG best practice in relation to the Statement of Investment Principles, and DWP's expectations across the Implementation Statement.

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SUMMARY OF THE PRI'S RESPONSE

The PRI welcomes the proposed reforms to Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021. We believe the Department has shown consistent and continued leadership in the roll out of TCFD-aligned disclosures, which have been further enhanced by the proposals on Paris-aligned metric disclosure, as laid out by this consultation.

The PRI also welcomes the marked focus on stewardship that is presented in the second chapter of this consultation. The PRI maintains that high quality stewardship standards are an essential component to managing and mitigating climate risk, as well as in the proper consideration and integration of other ESG and climate-related factors. We also believe that a marked focus on beneficiaries' views and preferences is of paramount importance when discussing good stewardship for pension schemes.

The PRI agree with the overall proposal outlined by this consultation. We welcome proposals in this consultation that closely follow the guidance laid out by the TCFD, including those that reflect the newly updated guidance[1].

KEY RECOMMENDATIONS

- **The PRI support the proposal to require trustees of schemes in scope to measure and report their scheme's Paris alignment by adding a requirement for them to select, calculate and report on a portfolio alignment metric in their TCFD report.** In addition, we recommend that the DWP distinguish between the different use cases of the portfolio alignment options.
- **The PRI support the use of a 1.5 aligned framework for Paris alignment.** In addition, we recommend, given certain methodological limitations present in the flow of data across the investment chain and different asset classes, that flexibility is accounted for during implementation of the proposals.
- **We recommend that the DWP explore clarifying regulation to make explicitly clear that trustees can, and in some cases must, consider sustainability outcomes in line with their fiduciary duty.** This notion is outlined comprehensively in the report A Legal Framework for Impact [2], which outlines that sustainability outcomes are relevant for all investors.

[1] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures, October 2021

[2] A Legal Framework for Impact report, released July 2021

RESPONSES TO SPECIFIC QUESTIONS

CHAPTER 1 – MEASURING AND REPORTING PARIS ALIGNMENT

Q1. We propose to amend the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 to require trustees of schemes in scope to measure and report their scheme's Paris alignment by adding a requirement for them to select and calculate a portfolio alignment metric and to report on that metric in their TCFD report.

Do you agree with this policy proposal?

Yes. The PRI supports this recommendation, as it codifies the newly updated TCFD guidance for pension schemes. In particular, the PRI support and welcome the flexibility on how investors should measure and disclose portfolio alignment to track progress against climate goals. Forward-looking metrics are important to holistically understand the speed of transition to a net zero model.

We recommend that the DWP distinguish between the different use cases of the portfolio alignment options. Not all of the alignment options presently have the same use case. An Implied Temperature Rise (ITR) score is a powerful communication tool. Yet, as documented in the forward-looking metric consultation guidance by the TCFD and in research by other bodies, such as The Alignment Cookbook,[3] the absence of the transparency of inputs and a common methodology between providers, at present, limits the ability of ITR to track progress towards climate goals. As such, it is premature for ITR to be used, even implicitly, to drive target setting, portfolio allocation and optimisation.

It is worth noting that the TCFD in its finalised guidance on Metrics, Targets and Transition Plans, did offer increased flexibility on how Paris Alignment could be met by asset owners, broadening it from the three options described in section 34 (page 14) of DWP consultation to "using whichever approach or metrics best suit their organisational context or capabilities" [4].

Q2. We propose that:

(a) trustees who are subject to the requirements in Part 1 of the Schedule to the Climate Change Governance and Reporting Regulations on or after 1 October 2022 (including trustees to whom the requirements are re-applied in accordance with regulation 3(4), 4(4) or 5(4)) will be required to select, calculate and report on a portfolio-alignment metric and to publish the findings in their TCFD report within 7 months of the relevant scheme year end date in the same way as they are for other metrics. This will apply to:

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[3] The Alignment Cookbook (2020) A Technical Review of Methodologies Assessing a Portfolio's Alignment with Low-Carbon Trajectories or Temperature Goal, Green and Sustainable Finance

[4] Implementing the Recommendations of the Task Force on Climate-related Financial Disclosures, page 41, October 2021

- **trustees of a trust scheme which had relevant assets equal to, or exceeding, £5 billion on their first scheme year end date which falls on or after 1st March 2020, and who remain subject to the requirements in Part 1 of the Schedule on 1 October 2022**
- **trustees of a trust scheme which has relevant assets equal to, or exceeding, £1 billion on a scheme year end date which falls on or after 1st March 2021**
- **trustees of all authorised master trusts and authorised collective defined contribution schemes**

The PRI welcomes the scope of firms captured by this proposal. However, the PRI recognise that some schemes in scope of this proposal would be required to disclose on Paris-aligned metrics before asset managers in scope of the FCA's TFCD-aligned regime will be required to do so. We acknowledge that this is not optimal as this may cause challenges in the flow of data availability for reporting schemes.

Q3. We propose to incorporate the requirements to measure and report a portfolio-alignment metric into the existing Climate Change Governance and Reporting Regulations so that the requirements are subject to the same disclosure and enforcement provisions as the other metrics requirements.

Do you agree with this policy proposal?

Yes. The PRI supports this proposal. For the newly proposed portfolio-alignment metric reporting to be an effective tool in accounting for and mitigating climate risk, it is important that the same disclosure and enforcement provisions apply. This is an essential component in naturalising and embedding Paris-aligned metric disclosure within existing reporting regulations for pensions schemes in scope of this consultation. To subject these proposed requirements to a different set of enforcement provisions, in the long term, may risk fragmentation in reporting and disclosure requirements and may therefore act to hinder efforts as set out by this consultation.

However, the PRI notes that data availability and methodological limitations, as outlined previously in this response, may initially present trustees with challenges in disclosing Paris-alignment. The PRI recommends that DWP consider, at least initially, implementing measures to allow flexibility while trustees adopt these new regulations. It may be appropriate that these include the administration of minor penalties for significant breaches in disclosure requirements.

It is important to note that smaller schemes may be adversely affected by these proposals, due to the comparatively lower availability of resources to dedicate to reporting. As such, measures should be taken to ensure that disproportionate reporting burden or penalties does not adversely affect smaller schemes.

Q4. (a) Do you have any comments on the draft amendments to the Regulations? (b) Do you have any comments on the draft amendments to the statutory guidance?

Please include in your answer any comments you have on whether you consider that they meet the policy intent stated in this chapter. We particularly welcome comments on the definition of a portfolio alignment metric and whether respondents think it reflects the policy intent?

The PRI support the draft amendments to a) the Regulations and b) the statutory guidance.

The PRI also supports the use of the 1.5-degree benchmark for Paris-aligned reporting and believe this does reflect the policy intent as outlined in this consultation. Referring to 1.5 degree Paris-alignment rather than the term "below 2.0" will provide trustees with a clearer and more ambitious framework to report within. As rightly acknowledged by this consultation, these forward-looking portfolio-alignment metrics are essential in helping trustees in their investment strategy, goal adoption and risk management ambitions.

We recommend that a wider range of alignment metrics should be included in the proposal, such as those outlined by the Paris-Aligned Investment Initiative's (PAII) Net Zero Investment Framework (NZIM) Implementation guide [5]. The PRI supports the use of the 1.5-degree benchmark and simultaneously acknowledges significant methodological challenges in measuring and creating a 1.5 degree aligned portfolio in a 4-degree aligned economy. The PRI recognise that there is an absence of suitable methodology and data availability that makes disclosure against the 1.5-degree benchmark difficult for some asset classes - including reporting and disclosures, it is therefore important that more flexibility around alignment metrics is incorporated into statutory guidance. Providing further flexibility for trustees may help to ensure smoother and more effective adoption of proposals.

Q5. Do you have any comments on the new regulatory burdens to business and benefits of requiring schemes to measure and report their Paris alignment?

The PRI maintain that accounting and disclosure requirements for all actors in the investment chain are an essential component in mitigating climate risk and ensuring that net zero goals are met. It is important regulatory requirements are distributed in a just and proportionate way throughout all factions of society, including businesses and financial institutions, so that the burden of reporting does not fall disproportionately on any one group.

There has been an increase in the number of governments making net zero by 2050 commitments, not least in the case of the UK recently publishing its Net Zero Strategy: Build Back Greener and Net Zero Review. European Union countries have also published 2030 emission reduction policy frameworks. As such, there is a business case for organisations operating in or with these markets to assess their strategic resilience to a 1.5-degree pathway.

It is nevertheless important to detail the challenges of this proposal, particularly how it is best for schemes to move beyond historic disclosures to forward-looking metrics.

[5] IIGCC's Net Zero Investment Framework Implementation Guide

We acknowledge that the underlying methodology for net zero target setting and alignment is currently insufficient, and that investors face fundamental challenges in creating 1.5-degree aligned portfolio in a 4-degree aligned economy.

Furthermore, we recognise that there is an absence of suitable methodology, models and data availability that could diminish the usability of disclosures and prevent the aggregation of weighted averages.

Ultimately it is imperative that all actors are responsible for disclosing and mitigating climate-risk, this in turn helps to ensure accountability for climate-related goals and other important societal issues. It is essential that concerns around business reporting to not curtail efforts to enhance climate-related reporting across the capital markets.

CHAPTER 2 – STEWARDSHIP AND THE IMPLEMENTATION STATEMENT

Q8. Do you have any comments on our cross-cutting proposals for the draft Guidance on Statements of Investment Principles and Implementation Statements, in particular that:

- **(a) they are written for members?**
- **(b) these are trustees' statements, not their consultants'?**
- **(c) Implementation Statements should set out how the approach taken was in savers' interests?**
- **(d) trustees should be able to include material from voluntary disclosures, such as Stewardship Code reporting, as long as they meet the requirements in the Regulations?**

The PRI welcome cross-cutting proposals for the draft Guidance on Statements of Investment Principles and Implementation Statements. Trustees do not delegate their fiduciary duties and nor therefore the responsibility to make clear how stewardship has been exercised to meet their duties via the implementation statement. Trustees' ownership of Implementation Statements that are more stringent will encourage greater accountability of investment managers and ultimately better outcomes for members.

Q9.

- **(a) Do you have any comments on our proposed Guidance on stewardship policies**

The PRI supports the proposed Guidance. We expect that encouraging trustees to set out their own stewardship policy covering both voting and engagement in relation to their stewardship priorities, or that of their managers if they do not, will reduce boilerplate disclosures.

Q13. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to financially material considerations (including ESG and climate change)?

And

Q14. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to non-financial matters?

In response to questions 13 and 14, the PRI recommend:

- the DWP explore clarifying regulation to make explicitly clear that trustees can, and in some cases must, consider sustainability outcomes in line with their fiduciary duty

ESG factors 'do not neatly divide between "financial" and "non-financial factors"' as noted in the DWP consultation published earlier this year on social risks and opportunities [6]. The PRI recommends that a focus on sustainability outcomes may be more effective than guidance for financial and non-financial matters.

Firstly, what trustees consider financially material or immaterial can vary per asset class, investment time horizon, and will diverge between investors. Secondly, what respondents may indicate as financially material factors today may not sufficiently take into consideration ESG factors that will have financial impacts on assets in the future. Thirdly, there is both difference and interplay between the way in which ESG issues can expose investors to greater idiosyncratic risk of a particular company or sector, and systemic risks, that are particularly relevant for universal owners, which can undermine sustainable value creation.

Different lenses on determining financial materiality and types of risk are especially important to take into consideration given the long-term liabilities of pension funds, and the role of trustees in setting investment frameworks, providing oversight for and instruction for (internal or external) managers to consider ESG issues across the investment time horizon of the fund.

These observations are supported by legal analysis undertaken by Freshfields Bruckhaus Deringer and commissioned by The Generation Foundation, PRI and UNEP FI in "A Legal Framework for Impact" report [7]. The report makes clear that sustainability outcomes are relevant for all investors, and that they have an obligation to consider doing so where it can help in pursuing their financial objectives. The report also finds that UK regulation is not as explicitly clear as it might be for investors to understand. As such we recommend that, rather than a focus on separate guidance for financial versus non-financial matters, the DWP explore clarifying regulation to make explicitly clear that trustees can, and in some cases must, consider sustainability outcomes in line with their fiduciary duty [8].

[6] DWP's consultation on Consideration of social risks and opportunities by occupational pension schemes, March 2021

[7] A Legal Framework for Impact report, released July 2021

[8] UK Annex of A Legal Framework for Impact report, released July 2021, pages 446 – 509

Such clarification if introduced into the Pensions Act could mirror Article 172 of the Companies Act in speaking to the broader purpose pensions investment and providing trustees with greater clarity that trustees have not only the opportunity to consider impacts under current pensions legislation but also a legal duty to *consider* impact, without compromising on the duty to target financial return.

- the DWP work with the Pensions Regulator (TPR) to provide further guidance on the integration of beneficiaries' views

We encourage the DWP to provide further guidance on how schemes can engage with their beneficiaries to better understand and incorporate member preferences into investment decisions.

In our guidance paper 'Understanding and aligning with beneficiaries' sustainability preferences' [9], the PRI has researched how beneficiary preferences have been understood to date and how our signatories seek to improve their understanding of this topic. A total of 14 signatories, primarily asset owners, have shared leading practices as well as challenges they encountered and how these may be overcome. Our guide seeks to help asset owners learn about and incorporate beneficiary preferences, which should be a fundamental aspect of an asset owner's investment strategy, policy and strategic asset allocation.

As a number of the PRI's UK asset owner signatories are already effectively incorporating beneficiary views and preferences in their investment decision making and strategy, the PRI believe that this not only very possible, but entirely necessary for best practice in investment stewardship. The success of beneficiary engagement platforms[10] exemplifies a strong case for more advanced pathways and processes for schemes to best engage with beneficiaries.

We believe that guidance from the DWP on integrating beneficiaries views would support trustees with a balance of guidance on decision-useful information commonly used by investors which is aligned with the development international standards and best practice, and ability to exercise discretion on their chosen approach.

A Legal Framework for Impact and ShareAction's Responsible Investment Bill[11] both emphasise the need to clarify investor duties and to incorporate beneficiary considerations in stewardship duties.

The PRI has experience of public policy engagement on sustainable finance policies and responsible investment across multiple markets and stands ready to further support the work of the Department of Work and Pensions to enhance climate-reporting and stewardship in the UK.
Any question or comments can be sent to policy@unpri.org.

[9] PRI's paper Understanding and aligning with beneficiaries' sustainability preferences, April 2021

[10] Examples of this include Tumelo and Citizen Shareholders

[11] ShareAction's Responsible Investment Bill: The Change We Need, November 2020