EXPLANATORY MEMORANDUM TO

THE OCCUPATIONAL PENSION SCHEMES (CLIMATE CHANGE GOVERNANCE AND REPORTING) (AMENDMENT, MODIFICATION AND TRANSITIONAL PROVISION) REGULATIONS 2022

2022 No. 733

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Work and Pensions (DWP) and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument introduces new requirements for trustees of certain occupational pension schemes to calculate and disclose a portfolio alignment metric describing the extent to which the scheme's assets are aligned with the climate change goal of limiting the increase in the global average temperature to 1.5°C above pre-industrial levels. The requirements will apply to trustees from 1st October 2022 according to the value of relevant scheme assets, or whether the scheme has been authorised for certain purposes. This is with a view to further ensuring that there is effective governance of those schemes with respect to the effects of climate change.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is Great Britain.

4.2 The territorial application of this instrument is Great Britain.

4.3 It is anticipated that the Department for Communities will make corresponding legislation for Northern Ireland.

5. European Convention on Human Rights

5.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

6. Legislative Context

6.1 The Pension Schemes Act 2021, section 124[1] (climate change risk) inserted new sections 41A to 41C into the Pensions Act 1995[2]. Section 41A confers powers on the Secretary of State to make regulations imposing requirements on trustees of occupational pension schemes with a view to securing that there is effective governance of the scheme with respect to the effects of climate change. Section 41B enables publication requirements to be imposed on trustees and section 41C enables

[1] https://www.legislation.gov.uk/ukpga/2021/1/section/124/enacted
[2] https://www.legislation.gov.uk/ukpga/1995/26/contents/enacted

the Secretary of State to make provision with a view to securing compliance with regulations made under sections 41A and 41B.

6.2 Following a public policy consultation[3], held between 26 August and 7 October 2020 and then a subsequent consultation[4] on draft regulations and statutory guidance, held between 27 January and 10 March 2021, DWP introduced a package of regulations which came into force on 1 October 2021.

6.3 The Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 (S.I. 2021/839)[5] ("the Principal Regulations") imposed requirements on trustees of certain occupational pension schemes with a view to ensuring that there is effective governance of those schemes with respect to the effects of climate change. The Occupational Pension Schemes (Climate Change Governance and Reporting) (Miscellaneous Provisions and Amendments) Regulations 2021 (S.I. 2021/857)[6] imposed related disclosure and notification requirements and new requirements about trustee knowledge and understanding of matters relating to the effects of climate change on occupational pension schemes.

6.4 This instrument amends the Principal Regulations, to require trustees of schemes within scope of those Regulations to calculate and disclose a portfolio alignment metric describing the extent to which the scheme's assets are aligned with the climate change goal of limiting the increase in the global average temperature to 1.5ºC above pre-industrial levels. This climate change goal is set out in article 2(1)(a) of the Paris Agreement (see paragraph 7.3)[7].

6.5 During Parliamentary passage of the Pension Schemes Act 2021, when speaking to the amendment which introduced section 41A of the Pensions Act 1995, Lords Minister Baroness Stedman-Scott indicated that any future proposals on the issue of Paris Agreement alignment reporting for occupational pension schemes would be put to consultation[8]. A public consultation – 'Climate and investment reporting: setting expectations and empowering savers'[9] – was held between 21 October 2021 and 6 January 2022.

7. Policy background

What is being done and why?

7.1 All pension schemes are exposed to climate-related risks, irrespective of their current investment strategy. Many schemes are also supported by employers or sponsors whose financial positions and prospects are dependent on current and future developments in relation to climate change.

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[3] https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes

[4] https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes-response-and-consultation-on-regulations

[5] https://www.legislation.gov.uk/uksi/2021/839/contents/made

[6] https://www.legislation.gov.uk/cy/uksi/2021/857/made

[7] See Article 2(1)(a) of the agreement adopted in Paris on 12 December 2015 at the 21st Conference of the Parties to the 1992 United Nations Framework Convention on Climate Change (the Paris Agreement): https://unfccc.int/sites/default/files/english_paris_agreement.pdf.

[8] https://hansard.parliament.uk/Lords/2020-02-26/debates/6AEE06F4-23E4-4F94-B5B4-C2BFBBD83108/PensionSchemesBill(HL)?highlight=reporting%20paris#main-content. See column 157GC.

[9] https://www.gov.uk/government/consultations/climate-and-investment-reporting-setting-expectations-and-empowering-savers

7.2 In order to ensure trustees are fully considering this risk and acting in the best interests of pension scheme beneficiaries, we embedded the Taskforce for Climate Related Financial Disclosure's (TCFD)[10] recommendations[11] in UK law in respect of occupational pension schemes by making the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021 which came into force on 1 October 2021 (with equivalent regulations coming into force at the same time in respect of Northern Ireland[12]).

7.3 In December 2015, 195 countries committed in the Paris Agreement[13] to holding the increase in the global average temperature to well below 2˚C above pre-industrial levels and pursuing efforts to limit the temperature increase to 1.5˚C above pre-industrial levels (Article 2.1(a)). The Agreement also aims to make finance flows consistent with a pathway towards low greenhouse gas (GHG) emissions and climate-resilient development (Article 2.1(c)). It states that, in order to achieve the long-term temperature goal set out in Article 2 of the Agreement, the Parties aim to reach global peaking of GHG emissions as soon as possible, and to undertake rapid reductions thereafter in accordance with best available science (Article 4.1).

7.4 In order to meet the 1.5 degrees global warming goal in the Paris Agreement, global carbon emissions need to reach Net Zero in 2050[14]. This transition will lead to a fundamental transformation of the global economy, affecting all types of pension schemes regardless of their investment portfolios. UK pension schemes' investments are internationally diversified, with overseas investment being a key element of the investment strategy, especially in relation to equities[15] and so are acutely affected by a global transition.

7.5 The TCFD's updated supplemental guidance[16] for asset owners now recommends that they describe the extent to which assets they own and their funds and investment strategies, where relevant, are aligned with a well below 2°C scenario.

7.6 Irrespective of whether schemes have sought to align their portfolio with Net Zero, a portfolio alignment metric may be a valuable tool for both assessing and communicating a scheme's transition risk and for identifying and communicating the priorities for scheme engagement, voting or ultimately divestment by highlighting firms which are furthest from alignment with climate goals or which make the biggest contributions to climate change.

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[10] The TCFD is a global, private sector led group assembled in December 2015 at the instigation of the international Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system.

[11] Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures (June 2017) - https://www.fsb-tcfd.org/publications/final-recommendations-report/

[12] https://www.legislation.gov.uk/nisr/2021/244/introduction/made

[13] The agreement adopted in Paris on 12 December 2015 at the 21st Conference of the Parties to the 1992 United Nations Framework Convention on Climate Change dealing with greenhouse-gas emissions mitigation, adaptation and finance signed in 2016 - https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement

[14] https://www.ipcc.ch/2018/10/08/summary-for-policymakers-of-ipcc-special-report-on-global-warming-of-1-5c-approved-by-governments/

[15] Estimates vary between 70 and 80% of quoted equity investments are invested overseas. See figure 7.5 of 'The Purple Book 2020' [DB schemes] - https://www.ppf.co.uk/sites/default/files/2020-12/PPF_Purple_Book_20.pdf and figure 23 of 'UK pension surveys: redevelopment and 2019 results' [direct holdings of equities across all schemes] - https://www.ons.gov.uk/releases/ukpensionsurveysredevelopmentand2019results

[16] See page 27 - https://assets.bbhub.io/company/sites/60/2021/07/2021-Metrics_Targets_Guidance-1.pdf

7.7 This instrument therefore introduces requirements reflecting the updated recommendations of the TCFD to ensure trustees of occupational pension schemes within scope of the Principal Regulations calculate and disclose a portfolio alignment metric describing the extent to which the scheme's assets are aligned with the goal of limiting the increase in the global average temperature to 1.5°C above pre-industrial levels.

7.8 This instrument will apply to trustees within scope of the Principal Regulations, including:

- trustees of a trust scheme (an occupational pension scheme established under a trust) 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 to the Principal Regulations 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; and
- trustees of all authorised master trust schemes and authorised collective defined contribution schemes.

Calculating portfolio alignment

7.9 Regulation 1 of the instrument specifies that the amendments the instrument makes to the Principal Regulations come into force on 1 October 2022.

7.10 Subject to modifications for certain schemes provided for in regulation 3 (see paragraph 7.17 below), regulation 2(2) of the instrument introduces a requirement for trustees to select a portfolio alignment metric to calculate in relation to the scheme's assets, in the first scheme year in which the requirements of Part 1 of the Schedule to the Principal Regulations apply to the scheme and, where applicable, in a first scheme year of re-application. A portfolio alignment metric is a metric which gives the alignment of the scheme's assets with the climate change goal of limiting the increase in the global average temperature to 1.5°C above pre-industrial levels.

7.11 To recognise that the availability and quality of certain climate-related data may currently be limited, but that this is expected to improve over time, trustees are required under amendments made to the Principal Regulations by regulation 2(2) of the instrument to obtain the data required to calculate the metric, use the data obtained to calculate the metric and then use the metric to identify and assess climate-related risks and opportunities relevant to the scheme "as far as they are able". This is defined in the Principal Regulations to mean that they must take all such steps as are reasonable and proportionate in the circumstances, taking into account the costs or likely costs which will be incurred by the scheme and the time required to be spent in taking such steps.

Reporting portfolio alignment

7.12 Regulation 2(3) of the instrument amends the Principal Regulations to require trustees to include specified information about their portfolio alignment metric in the scheme's climate governance report ("Task Force for Climate-related Financial Disclosures (TCFD) report"), which they are required to produce and publish under the Principal Regulations.

7.13 The Principal Regulations require trustees to produce and publish the TCFD report on a publicly available website, accessible free of charge, within 7 months of the end of any scheme year in which they were required to comply with the requirements of Part 1 of the Schedule to the Principal Regulations (subject to certain exceptions). It is therefore expected that, once subject to the Principal Regulations, trustees will produce and publish a report in respect of each scheme year, unless one of the exceptions set out in the Principal Regulations applies.

7.14 Including a portfolio alignment metric in the TCFD report, recognises the growing government, regulatory, industry and public interest in the sustainability and wider socio-economic value of investment practices. Portfolio alignment reporting specifically has the potential to be particularly impactful when communicating a scheme's progress in transitioning to Net Zero. This will be especially true as methodologies standardise, variability reduces, and outcomes become more comparable.

7.15 It is now well established that the majority of pension scheme members care about climate change and the impact it will have on their savings, the environment and wider society. The Defined Contribution Investment Forum's 2020 survey[17] on responsible investment found that 70% of members have now declared an interest in responsible investment up from 61% just two years earlier, with 73% declaring they feel strongly about environmental issues and 87% feeling businesses have wider societal responsibilities beyond making a profit.

7.16 We believe that Paris alignment reporting can facilitate this engagement further and has the potential to be a particularly powerful tool for communicating a scheme's progress in managing the transition to Net Zero to members. By providing a reasonably simple representation of a complex concept, portfolio alignment metrics can provide scheme members with a more straightforward way to understand the scheme's progress in becoming Paris aligned and potential exposure to transition risk.

Modification and transitional provision

7.17 Amendments made by this instrument to paragraphs 15 and 21 of the Schedule to the Principal Regulations would require or enable trustees to do certain things in the first scheme year in respect of which the requirements of Part 1 of the Schedule to the Principal Regulations apply. In respect of certain trustees, to whom the modifications in regulation 3 apply, that first scheme year may have already ended when this instrument comes into force. The modifications in regulation 3 therefore ensure that, in respect of those trustees to whom the modifications apply, such activity will be required or enabled in the scheme year which is underway on 1 October 2022. This ensures that the way in which the relevant new provisions in the Principal Regulations will apply to these trustees is consistent with other trustees subject to those provisions from 1 October 2022.

7.18 Regulation 4 modifies paragraph 21 of Part 1 of the Schedule to the Principal Regulations, in respect of certain trustees, for the purposes of amendments made by regulation 2(2)(b) and (c) of the instrument. This ensures that - in a scenario where trustees of a scheme are required to comply with the requirements of Part 1 of the Principal Regulations from 1 October 2021 but fall out of scope of those requirements before 1 October 2022 and then fall back into scope at a later date – in the first

[17] The Key to Unlocking Member Engagement, Defined Contribution Investment Forum - https://dcif.co.uk/wp-content/uploads/2020/07/the_key_to_unlocking_member_engagement.pdf

scheme year in which the new requirement at new paragraph 19A of the Principal Regulations applies, they can also rely on the easement set out in paragraph 21 of the Schedule to the Principal Regulations in respect of the relevant new portfolio alignment metric requirements, as it is the first time the trustees have to select and calculate a portfolio alignment metric.

7.19 Regulation 5 of this instrument ensures that the requirement to include information about a portfolio alignment metric in the Task Force for Climate-related Financial Disclosures (TCFD) report does not apply in respect of a scheme year which ends before 1 October 2022. This is to ensure that where trustees produce or publish a TCFD report after 1 October 2022, which relates to a scheme year that ended before that date, they are not required to report on a portfolio alignment metric.

8. Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act.

9. Consolidation

9.1 Informal consolidated text of instruments is available to the public free of charge via 'the National Archive' website[18].

10. Consultation outcome

10.1 We put our policy proposals to a public consultation[19], held between 21 October 2021 and 6 January 2022 for 11 weeks. The consultation was supported by meetings with stakeholders and smaller groups of industry and legal experts to examine the detailed proposals, the financial impact of the proposed changes and the draft regulations and draft statutory guidance.

Consultation on the policy proposals, Draft Regulations and Draft Statutory Guidance

10.2 We received 60 responses to the consultation itself. These were made up of 9 from corporate occupational schemes; 8 from trade bodies; 7 from membership bodies; 8 from dedicated consultancy firms, 5 dedicated master trust sponsors, and 3 that do both consultancy and operate a master trust; 5 from asset managers; 3 from law firms; 3 from Local Government Pension Scheme (LGPS) bodies; 3 civil society bodies; and 1 each from a statutory public pension fund, a non-profit research company, a campaign group, a global finance company, an individual consultant and a think tank.

10.3 The responses were largely positive in relation to the principle of introducing a mandatory requirement to calculate and report a portfolio alignment metric. There was almost unanimous support for including the metric in schemes' TCFD reports, by amending the Principal Regulations, and thus, ensuring it is subject to the same disclosure and enforcement provisions as other metric requirements. However, several respondents expressed concerns on availability and quality of the data key to calculating portfolio alignment metrics, timing of the roll-out and burdens. A very small minority of respondents were opposed to any further action being taken at all.

[18] https://www.legislation.gov.uk

[19] https://www.gov.uk/government/consultations/climate-and-investment-reporting-setting-expectations-and-empowering-savers

10.4 Despite acknowledging some of the concerns raised in response to the consultation, we have not made any substantive changes to our original policy proposals. We have however, made a number of changes to the draft regulations and draft statutory guidance, to provide clarity in light of the responses received. Full details can be found in the Government's consultation response[20].

11. Guidance

11.1 In complying with the requirements of the Principal Regulations which this instrument amends, trustees are required by sections 41A(7) and 41B(3) of the Pensions Act 1995[21] to have regard to statutory guidance prepared by the Secretary of State.

11.2 The statutory guidance "Governance and reporting of climate change risk: guidance for trustees of occupational schemes" is published on Gov.uk and will be reviewed as a minimum every three years, from the first date of publication, and has been updated to reflect the new requirements imposed by this instrument.

12. Impact

12.1 The impact on business, charities or voluntary bodies is principally on the pensions industry, specifically Occupational Pension Schemes with £1bn or more in relevant assets, and both master trusts (multi-employer defined contribution schemes) and schemes offering collective money purchase benefits which have been authorised by The Pensions Regulator. Costs principally stem from requiring pension schemes in scope to calculate a portfolio alignment metric.

12.2 There is no, or no significant, impact on the public sector.

12.3 A full Impact Assessment has not been prepared for this instrument because the Impact Assessment on climate change risk - governance and disclosure (TCFD) proposals[22] covers existing TCFD regulations and the extension for schemes to calculate a portfolio alignment metric is a requirement insofar as trustees are able. On the balance of the evidence provided in response to the consultation, we do not expect any notable additional burdens to those already accounted for in the impact assessment, which estimated an annual net cost to business of £6.2 million.

13. Regulating small business

13.1 The legislation does not apply to activities that are undertaken by small businesses.

14. Monitoring & review

14.1 Guy Opperman MP, Parliamentary Under-Secretary of State for the Department for Work and Pensions, has made the following statement under section 28(2)(b) of the Small Business, Enterprise and Employment Act 2015.

[20] https://www.gov.uk/government/consultations/climate-and-investment-reporting-setting-expectations-and-empowering-savers
[21] https://www.legislation.gov.uk/ukpga/2021/1/section/124
https://www.legislation.gov.uk/ukpga/2021/1/part/5/crossheading/climate-change-risk/enacted
[22] https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes-response-and-consultation-on-regulations/impact-assessment-on-climate-change-risk-governance-and-disclosure-tcfd-proposals

14.2 "Having had regard to the Statutory Review Guidance for Departments published under section 31(3) of the Small Business, Enterprise and Employment Act 2015, in my view, it is not appropriate to make provision for review in the Occupational Pension Schemes (Climate Change Governance and Reporting) (Amendment, Modification and Transitional Provision) Regulations 2022."

14.3 We recognise the importance of monitoring and evaluating the initial impact of our regulations. The legislation does not include a statutory review clause; however, we have already publicly committed to undertake a review of the Principal Regulations that this instrument is amending in 2023. This will cover all the aspects normally required by a statutory review clause.

15. Contact

15.1 Thomas Rhodes at the Department of Work and Pensions, Email: thomas.rhodes@dwp.gov.uk can be contacted with any queries regarding the instrument.

15.2 Jo Gibson, Deputy Director for Private Pensions and Arms Length Bodies, at the Department of Work and Pensions can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Minister for Pensions and Financial Inclusion, Guy Opperman at the Department for Work and Pensions can confirm that this Explanatory Memorandum meets the required standard.