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7 October 2020

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Submitted via: pensions.governance@dwp.gov.uk

**Consultation regarding pension schemes' governance and reporting on climate related risk**

Dear David,

State Street Corporation welcomes the opportunity to provide comments on the Department of Work and Pensions' ("DWP") proposals, entitled *'Taking action on climate risk: improving governance and reporting by occupational pension schemes',* which essentially seek to codify the recommendations of the international Taskforce on Climate-Related Financial Disclosures ("TCFD") by requiring trustees of larger occupational pension schemes and authorised schemes to address climate change risks through governance and risk management measures.

State Street is a leading provider of financial services to institutional investors, which includes investment servicing, investment management, and investment research and trading. With $33.52 trillion in assets under custody and/or administration and $3.05 trillion[1] in assets under management, State Street operates globally in over 100 geographic markets. In the United Kingdom, State Street Bank & Trust Company provides custody services to more than 160 domiciled pension funds; State Street Global Advisors' total UK pension assets under management is $83 billion, with defined benefit ("DB") – including the Local Government Pension Scheme ("LGPS") – representing approximately $30 billion, and defined contribution ("DC") representing approximately $53 billion.[2] Our comments

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[1] AuM as of 30 June 2020 includes approx. $67 billion of assets with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and SSGA are affiliated
[2] AuM as of 30 June 2020

are therefore formed on the basis of these two perspectives in addition to those of the trustees overseeing State Street's own occupational pension scheme.

As an asset manager and fiduciary of the assets that our clients entrust to us, State Street has a duty to act prudently and in the best interests of our clients; increasingly, this entails consideration of environmental, social and corporate governance ("ESG") factors, including climate change, relevant to the performance of the companies in which our clients invest. We have long stated that addressing material ESG issues is essential to a company's long-term financial performance --- a matter of *value*, not *values*.

***The value of integrating material climate-related risks into investment decisions***

For long-term investors like pension funds, the systematic integration of ESG factors into investment strategies allows plans, participants and beneficiaries to access an entire type of long-term, value-driven investment, for which a growing body of academic and market research suggests could help ensure future retirement security. In the case of pension funds, this is largely driven by concern that risks stemming from climate change, in particular, could result in a significant loss of value in pension scheme investments.

Furthermore, and partly also a result of the proliferation of both voluntary and mandatory climate-related disclosures, pension scheme members are increasingly setting high expectations of how pension funds and the investment managers that invest on their behalf are addressing climate risk. As long-term investors, we also think that pension funds are well positioned to benefit from potential opportunities relating to the broader sustainability transition.

For State Street Global Advisors, ESG or climate-related investing is first and foremost about managing risk and capturing both tangible and intangible value drivers for companies, and pension plans. As stated, our approach to the holistic integration of material sustainability factors, including climate change, into investment strategies is about investor "value" versus "values" and so the emphasis that the DWP places on "financial materiality" is highly welcome, and commensurate with our investment conviction.

***Requirements need to be calibrated in accordance with the structure of the UK pensions market***

It is first important to consider the structure of the UK pensions market, which is split into DB and DC schemes, and whether this renders a difference in demand or appetite toward ESG/sustainability-related investing. While the DWP's proposals appear to focus on DB schemes, the proposed requirements would extend to Master Trusts, which are predominantly DC. DB schemes are made up of both private (60%) and public sector (40%) schemes. In the case of corporate schemes, the vast majority (99%) are closed to new members and future benefits accrual.

Therefore, their investment strategy is geared to matching their liabilities (pension payments) as they fall due, rather than alpha generation. Their investment policy tends to be comprised of gilts and corporate bonds with a derivative overlay to cashflow match.

Public sector schemes, for example LGPS, on the other hand, are fully open to new members and future accrual. They are interested in long-term capital growth, leveraging the illiquidity premium as their investment time horizon is effectively open-ended. LGPS are also well-organised as a collective --- there are 104 such schemes in the United Kingdom, and all those in England and Wales have or are in the process of consolidating their assets into eight pension pools. They have a broadly similar investment strategy and can adopt common investment policies, which can be titled towards ESG/sustainability, climate targets, etc.

Taking the above into consideration, there may be an argument to suggest that there is limited relevance in requiring trustees of corporate schemes to implement TCFD recommendations. We therefore recommend that the DWP prioritises it work on other pension schemes because indeed whilst corporate schemes currently have the greater share of the DB market, this will be diminished over time since they are mostly closed to new members.

***Access to reliable, comparable and consistent data***

We have been supportive of former DWP guidance recommending pension schemes voluntarily implement the TCFD principles. Proactively identifying and managing climate-related risks and opportunities, and communicating how they are being managed to clients and their end beneficiaries, has been a priority for the investment community. For any future disclosures to be truly meaningful, however, there needs to be further consideration about how material environmental or climate change-related information is disseminated along the full length of the investment chain.

More generally, access to reliable, comparable and consistent sustainability-related data has, in our view, hampered widescale implementation of the TCFD principles to date. We appreciate that the DWP acknowledges this data challenge and note the proportionate stance throughout the proposals whereby trustees would be obliged to satisfy any new statutory requirements “as far as [they] are able to”. While this stance is helpful, the nascency of reliable and consistent of data imposes significant pressures and constraints on pension trustees, which are understandable as they occupy positions of trust. This is why the DWP’s former guidance clarifying trustees’ duties as regards ESG/sustainability was well received.

Nevertheless, the data challenge exudes beyond the ability for trustees to effectively consider pension funds’ needs of quality climate-related disclosure from their investment managers, who in turn are fundamentally reliant on there being quality climate-related disclosure from investee companies. While many firms are working to develop a full set of TCFD disclosures, this is still an area of innovation and we are concerned that an overly prescriptive framework for pension schemes, at least in terms of conducting scenario analysis, would stifle that innovation. With regard to climate scenario analysis our concern rests on the vastly divergent approaches that are available in the marker, which would render it difficult for pension schemes, trustees and investment managers to quantify and model risks stemming from climate change, even on a 'best efforts basis'. As such, we would be supportive of initiatives, in public-private partnership, to establish appropriate adverse climate scenarios on which pension schemes and other financial market participants can utilise.

Furthermore, we disagree with the DWP's proposal to require pension schemes to obtain emissions and non-emissions based data and calculate and measure performance against selected targets "at least quarterly". [3] Such a requirement would be highly impractical, particularly when rolling the proposed regime out to smaller pension schemes, but it would also be disproportionate to require quarterly disclosure given investee companies would only be expected to disclose sustainability-related information to the market on a yearly basis (in their Annual Reports and Accounts).

***Coherent expectations across the investment chain***

Across State Street, we are actively supporting industry efforts to increase the overall financial system's ability to assess and mitigate climate change risk. This includes being a signatory to, and proponent of, the TCFD framework, which was developed to harmonise climate-related financial risk disclosures for companies to investors, lenders, insurers, and other stakeholders. The DWP is well aware that each of the TCFD's core pillars – governance, strategy and risk management arrangements – are open to interpretation. Hence, 'benchmarks', or standards, will be needed in order for legislation to be effective. In particular, the description of 'Metrics and Targets' requiring trustees to select one appropriate greenhouse gas (GHG) emissions-based metric and one other non-emissions-based metric would need to be further specified (see targeted comments below).[4] State Street's research groups are engaged in industry efforts to coalesce around standard methodologies, metrics, and reporting in line with the TCFD principles to help promote greater transparency around climate risk.

It is clear from our engagements with clients across State Street's businesses – be it either as stewards or custodians of our pension fund clients' assets – asset owners, investment managers, investee companies as well

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[3] Chapter 3: Climate governance and TCFD - 'Ongoing and discrete duties' para 27
[4] Chapter 3: Climate governance and TCFD – 'Metrics & Targets' para 75 - 103

as other stakeholders across the broader value chain are on a journey to understand and manage the impact of climate change on their business models and investment strategies. Further collaboration is essential to improve standardisation by identifying the best methodologies to quantify and manage the risks and opportunities associated with climate change. This means developing common, industry-wide benchmarks/metrics, and accompanying standards, that can be reviewed on a periodic basis. It is especially important given the DWP's proposals envisage penalties that trustees could face (albeit such penalties would appear to be applied only in the absence of any TCFD-style reporting).

***Ensuring the DWP proposals align with future industry-led initiatives***

Finally, we refer the DWP to a recent initiative whereby twelve of the UK's leading investment consultants have formed a Sustainability Working Group with a view to improving sustainable investment practices across the investment industry. This initiative is committed to engaging across a broad range of stakeholders – including asset owners, asset managers and regulators – with a view to creating a guiding set of principles that indicate good practice with practical advice. The work of these investment consultants will be a helpful basis on which pension schemes and the wider value chain can consistently and effectively articulate material risks and opportunities stemming from climate change. We therefore encourage the DWP to ensure all industry initiatives and comparable regulatory initiatives are thoroughly considered and aligned with any future statutory measures.

***Targeted State Street comments on specific DWP proposals***

With respect to the specific questions raised in this consultation, there are certain areas that we believe our experience in TCFD reporting capabilities can add most value, including regarding some of the challenges:

1. <u>Chapter 1 Scope and timing:</u>

   (a) <u>Appropriate to phase implementation according to pension scheme size</u>: notwithstanding our introductory comments regarding the relevance of TCFD reporting for corporate DB schemes, we agree with the DWP's approach to phase in TCFD-related requirements for pension schemes based on their size, initially targeting those with more than £5 billion in net total assets. As recognised by the DWP, smaller pension schemes are unlikely to have the prerequisite resources and expertise to satisfy the proposals by October 2021.[5] Furthermore, it would be appropriate to ensure alignment in terms of compliance timing between the DWP proposals with other initiatives aiming to accelerate TCFD adoption (e.g., the 12 investment consultants' project

[5] Chapter 2: Scope and Chapter 4: Disclosing TCFD (para 4).

noted above and, if finalised, the Financial Conduct Authority proposals on improving climate-related disclosure[6] are not expected to yield any enhanced reporting until 2022).

(b) Further clarification on assets to be captured by the £5bn threshold: in addition, it is reasonable to assume that when determining whether any ensuing legislation applies, UK gilts would be included in the computation of total net assets, for which mature DB schemes would have significant holdings. This ought to be clarified with confirmation that the Government would provide relevant data to UK bondholders (i.e. including pension schemes) to facilitate requirements on trustees to disclose in line with TCFD – the current public toolkits highlighted by the DWP in its earlier guide for trustees aligning their pension schemes with TCFD would not suffice alone.[7]

2. Chapter 4 Disclosing TCFD:

(a) Further guidance and standardisation are essential: as stated in our introductory comments, pension schemes will need to heavily rely on enhanced TCFD-related information from investment managers, who in turn will need to need to be able to obtain quality TCFD disclosures by investee companies. Aside from there being clear challenges in obtaining such data, as mentioned above, it would be important to ensure that information flows across the wider investment chain to facilitate the disclosure of climate-related information must also implemented in a standardised manner. We recognise that the FCA work to improve issuers' disclosures will be instrumental to improving climate data on investee companies, we believe that reporting templates, utilised for the exchange of data between investment managers and pension schemes, would be needed to effectively facilitate greater transparency and standardisation.

(b) Expanding the metrics to calculate emissions-based figures: we disagree with the DWP's proposal to require trustees to calculate and disclose "at least one emissions-based metric and at least one non-emissions-based metric used to quantify the effects of climate change on the scheme and assess climate-related risks and opportunities". The TCFD examined pre-existing descriptions, formulas and additional information for common "carbon footprinting" and exposure metrics in June 2017. This included the "weighted-average carbon intensity" (WACI) that the TCFD recommended asset owners and asset managers report to their beneficiaries and clients as well as other metrics that they should consider reporting. With that exercise, the TCFD identified advantages

[6] UK FCA 'Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations', https://www.fca.org.uk/news/press-releases/fca-announces-proposals-improve-climate-related-disclosures-listed-companies, March 2020
[7] The DWP quick start guide notes three sources for data: the Transition Pathway Tool, the PACTA tool, and Bank of England data on the potential impact of the low-carbon transition on 'high-risk sectors'

and disadvantages with carbon footprinting and WACI. As such, we recommend that the DWP requires trustees to calculate and disclose against the following three GHG emission-based metrics for disclosure:

- Total Carbon Emissions (in tCO2e)
- Carbon Footprint (in tCO2e / $M invested)
- Weighted Average Carbon Intensity or "WACI" (in tCO2e / $M revenue)

We believe that better comparability and consistency could be obtained by extending the requirement to these three common metrics listed above. This would also be in line with the incoming EU sustainable finance disclosures.

(c) Defining consistent calculation methodologies: The DWP proposal omits prescribing any calculation methodologies, but we think this is a mistake given existing practices in this area. A common factor of divergence between current disclosure frameworks and regulations is the normalisation factors used to calculate the portfolio attribution of carbon emissions disclosed by an issuer. For instance, TCFD uses "market capitalisation" as normalisation factor, whereas EU policymakers use "enterprise value"[8] and even "enterprise value including cash".[9] In addition, industry utilises alternative normalisation factors for certain asset classes: for example, for sovereign bonds, carbon emissions could be normalised by the Gross Domestic Product ("GDP"), or even usage of country population. Given the differences in approach, we believe that a detailed formula should be provided to trustees so as to avoid room for interpretation, or "cherry-picking" of practices.

(d) Challenges of climate scenario analysis: The DWP proposes to require trustees to assess the resilience of their assets, liabilities and investment strategy/funding strategy in at least two climate-related scenarios: one of which must be a 2°C or lower scenario and to disclose the results of this assessment. From our experience as an asset manager, while we fully agree that requiring pension schemes to perform climate scenario analysis is an optimal outcome of this consultation, there are no formal standards or guidance by which they can perform such analysis. We therefore think this should be a progressive goal of any future statutory measures. In fact, we would encourage the UK Government to leverage its expertise as part of the Network for Greening the Financial System, which has produced guidance around climate scenario analysis, and collaborate with a

[8] Joint ESAs consultation on this consultation paper setting out the proposed Regulatory Technical Standards (RTS) on content, methodologies and presentation of disclosures under the *Sustainable Finance Disclosure Regulation* (SFDR)
[9] Regulation (EU) 2019/2089, known as the Low Carbon Benchmarks Regulation amending Regulation (EU) 2016/1011

variety of stakeholders via the Climate Risk Financial Forum, with a view to establishing common examples of climate scenarios that financial market participants could use.

***Above all else, an orderly sustainability, or 'green', transition is essential***

Furthermore, we would highly appreciate clarity from the UK Government and the regulators on their plans to achieve carbon-neutrality by 2050, given a 'disorderly' transition could have a detrimental impact on the wider investment community should market participants not be sufficiently prepared well in advance. The DWP's proposal intends to take heed of any future sectoral legislation, but these efforts are a timely reminder that such clarity would be needed sooner, rather than later, to ensure an orderly sustainability transition. This means ensuring an appropriate sequencing of legislative initiatives whereby the entire investment chain is compelled, via enhanced transparency, to aid various governmental climate goals.

Moreover, the need for international collaboration on ESG/sustainability is greater now than ever before, and we appreciate the UK Government has been instrumental in bringing together global policymakers on this important topic. Nevertheless, it would be remiss to not emphasise that we remain concerned that the growing dichotomy between major jurisdictions on environmental and climate change matters, particularly in the pensions space, will hamper fiduciaries' ability to comply with any disclosure requirements in a meaningful way.

Ultimately, asset owners, including pension funds, set the tone for the responsible allocation of capital across the investment chain. Strong signals from pension funds, accompanied by enhanced TCFD disclosures from investee companies, will reinforce the mandate that investment managers have to manage the financial impact of climate change on behalf of clients. Hence, the awareness of climate risk, and the effective integration of it into our investment approach, is critical to supporting long-term returns for pension savers.

We hope that you find these comments useful and thank you once again for the opportunity to respond to the paper. We appreciate the DWP's engagement on this matter and please do not hesitate to contact me should you have any questions on the content of our submission.

Yours Sincerely,

Cuan Coulter

**Cuan Coulter**

Executive Vice President, Country Manager United Kingdom - State Street