Can climate change covenant?

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Pension scheme trustees need to understand the impact of climate-related risks and opportunities on the strength of the employer covenant. Employers with defined benefit (‘DB’) pension schemes should be prepared to provide information on how those risks and opportunities are being addressed.

What is happening?

- Climate change poses an existential threat to life on Earth as we know it and will require the combined efforts of government, society, and business to overcome.
- As part of the government’s decarbonisation strategy, the Department for Work and Pensions (‘DWP’) published its regulations and statutory guidance for pension scheme trustees on [governance and reporting of climate change risk] in June 2021. This follows on from the inclusion of climate change governance and reporting provisions in the Pension Schemes Act 2021 and ahead of The Pensions Regulator’s (TPR) consultation over the summer of 2021 to help trustees assess, manage and report on climate-related risks.
- To date, much of the conversation on the actions that pension scheme trustees should take in respect of climate-related risks has been centred on investment policy and decisions. However, given the key role employer covenant plays in integrated risk management, the consideration of the impact of climate-related risks on the employer and its ability to support its pension obligations is of critical importance.

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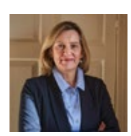

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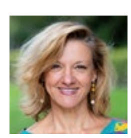

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Why is it an issue for pension scheme stakeholders?

The DWP's statutory guidance recognises *"the [employer] covenant is a significant source of support for most DB schemes"* and that *"as part of their assessment of the resilience of the funding strategy, trustees of DB schemes must consider the impact of climate-related risks and opportunities over the short, medium and long-term time horizons"*.

Climate-related risks have the potential to impact employer covenant via one-off events or progressively over time as we transition to a lower carbon economy.

Specific examples of covenant impacts which may cut across different sectors and markets include:

- Increased frequency of extreme weather events disrupting operations / supply chains in addition to increased risk of physical damage to assets;
- Increased costs arising from regulation and taxation designed to mitigate and adapt to climate change (potentially weakening affordability); and
- Reputational damage if businesses are perceived to not be responding to stakeholders' expectations on climate change, ultimately impacting customer demand for products, access to investment and the value of the enterprise.

Trustees of occupational pension schemes will be required to report in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), specifically in the following areas:

- **Governance** – disclosure of the framework in place around climate related risks and opportunities;
- **Strategy** – potential and actual material impacts of climate-related risks and opportunities on an organisation's business, strategy and financial planning;
- **Risk Management** – how climate-related risks are identified, assessed, and managed; and
- **Metrics & Targets** – used to assess and manage material climate-related risks and opportunities.

Accordingly, employers with DB pension schemes should expect trustee queries on climate-related risks and opportunities and to be prepared to provide information on how they are being addressed.

TPR's recent survey findings showed that DB schemes are not as prepared as they should be ahead of upcoming regulations on climate change disclosures. Only 49% of the 250 respondents indicated they had "allocated time or resources to assessing the financial risks or opportunities associated with climate change".

Whilst disclosure requirements will be phased in over time and only initially mandatory for schemes with assets of at least £5bn by 1 October 2021 and £1bn by 1 October 2022, trustees of all DB schemes need to be thinking now about the holistic impact of climate change on the employer covenant, given that it drives funding strategy and, in turn, the required target for investment returns.

What are the next steps?

Trustees and employers can get on the front foot by engaging collaboratively to identify the key risks and opportunities posed by climate change to the employer covenant.

By establishing ongoing dialogue and information sharing, both parties can ensure that this assessment remains relevant and up to date, allowing accurate reporting and timely response to any emerging risks.

At Teneo, we draw upon our combined expertise in employer covenant matters and in advising major corporates on energy transition and climate change strategies to support stakeholders in developing a considered, proportionate, and risk-focused approach.

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