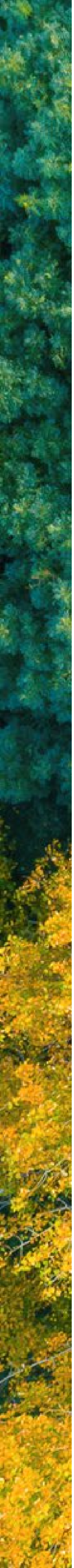


CLIMATE CHANGE REVOLUTION

A revolution is taking place before our eyes in the area of Environmental, Social and Governance (**ESG**) issues across financial services. Among the many facets of ESG, this article centres on the "E" and the increasing global focus on the climate emergency. Notably, this shift happens against the backdrop of the pandemic, in which some are drawing a connection between biodiversity degradation and more frequent global health pandemics. The link between environmental and human health is a stark reminder of our responsibilities.

In the insurance sector, recent developments in Europe, the UK, and globally have focused on the need to "green" the financial system. The UK government's Green Finance Strategy intends to de-carbonise the UK's financial system through a shift toward investment in green sectors and low carbon technologies. The UK government was one of the first to commit to net zero greenhouse gas emissions by 2050 and has just announced its revised target to reduce emissions by 78% by 2035 compared to 1990 levels.

The Taskforce on Climate-related Financial Disclosure (**TCFD**) recommends a set of clear, comparable, and consistent disclosures about the risks and opportunities presented by climate change. On 9 November 2020, the UK government announced that it intends to make it mandatory for large companies and financial institutions across the UK economy to make climate-related disclosures aligned with the TCFD recommendations by 2025. The roadmap published by HM Treasury sets out a strategy for seven categories of organisations: listed commercial companies, UK-registered companies, banks and building societies, insurance companies, asset managers, life insurers and FCA-regulated pension schemes as well as occupational pension schemes.

Following the roadmap, on 24 March 2021, the UK government's Department for Business, Energy & Industrial Strategy (**BEIS**) launched a consultation seeking views on its proposals to mandate climate-related financial disclosures by publicly quoted companies, large private companies, and limited liability partnerships in line with 4 pillars of TCFD (Governance, Strategy, Risk Management and Metrics and Targets). . For premium listed companies, these disclosures will be tiered with the new 'comply or explain' TCFD disclosures mandated by FCA due to be included in annual reports from 1 January 2022.
The Prudential Regulation Authority (**PRA**) has set out its expectations for insurers to manage climate change risk, and made clear that insurers must fully embed their approaches by the end of this year. Boards need to understand and assess financial risk from climate change and set an appropriate climate-related financial risk appetite. We already expect senior managers responsible for climate-related financial risk to be in place who will support and oversee the updating of risk management and governance frameworks. Large UK insurers will also be participating in the Climate Biennial Exploratory Scenario, this year's Bank of England resilience testing of the financial system to the physical and transition risks from climate change, with specific stress tests measuring their exposure according to different climate change-related scenarios reflecting degrees of achievement against the Paris Agreement. 2021 will therefore be a big year in ESG for the insurance industry.

In the occupational pension schemes world, 2021 is also proving to be an important year with the passing of the Pension Schemes Act 2021 (the **Act**), which was somewhat controversial. In the context of the ESG agenda, the Act provides for regulations that impose climate-related requirements on trustees of pension plans with more than £5bn in assets from October 2021 and schemes with more than £1bn in assets from October 2022 (the **Regulations**). These Regulations, impose governance and reporting requirements in line with TCFD recommendations, regarding the management and oversight of climate-related risks, and the management and monitoring of the schemes' exposure to such risks, and measuring these against specific scenarios and metrics. The Regulations require trustees to assess the assets of relevant schemes against prescribed climate-related risks and to account for the contribution of those assets to climate change metrics. Trustees will have to work out the scheme's carbon footprint by calculating greenhouse gas emissions of their investment portfolio and set climate-related targets.

The Pensions Regulator (**TPR**) issued its Climate Change Strategy in early April 2021, which adds detail to how it sees the roadmap toward net zero in 2050 and provides helpful background to its expectations of trustees. TPR intends to set out clear standards and to ensure that trustees comply with them. TPR guidance will clarify how schemes should assess, manage, and report under the Act's climate change provisions. Although initially applying to master trusts and larger schemes, TPR will also likely expect smaller schemes to engage with climate risks and responsibilities. The new code of practice for trustees and updates to the Trustee Toolkit will also include modules dedicated to climate change.

What does this mean for the pension scheme risk transfer market?

Relevant insurance contracts are taken into account when determining whether the Regulations apply to a scheme based on the value of its relevant assets. Essentially, the test excludes bulk annuity contracts by an insurer which are "intended in all circumstances to fully meet the cost of specified benefits….. and which are, or will become, payable in accordance with the scheme rules" and where the insurer has full and ongoing discretion over the investment policy for any assets used to meet its liabilities under the contract.
Schemes that have entered into bulk annuity contracts will, therefore, need to assess whether their existing contracts satisfy these requirements as that may determine the need to fully comply. Such assessment may be murky, since individual terms included in specific contracts may be problematic given that the Regulations require a fulsome level of coverage with a high bar of certainty before the contract can be assessed as a "relevant insurance contract" (noting the use of "in all circumstances" and "fully meet the cost" in the definition).

That said, the new regime expressly acknowledges the important and unique role that bulk annuity insurance might play when assessing a scheme's assets for climate-related impacts and that insurers who do have discretion over investment management are themselves in the driver's seat. TPR says it intends to work with other regulators to ensure a consistent and holistic approach to managing climate-related risks going forward.

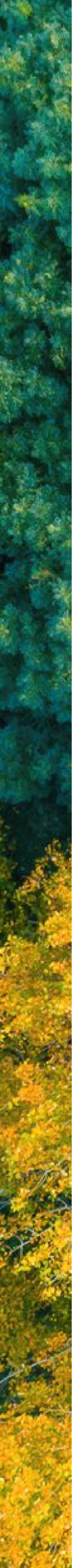
Note, however, that we expect the Regulations to dial up the importance of climate-related risks in bulk annuity transactions going forward, despite the exclusion of relevant bulk annuity assets in assessing the application of the Regulations. First, those who do enter into new bulk annuities will no doubt have their eye on the requirements for the contract to be a relevant insurance contract if they wish to fall outside the scope of the Regulations, either imminently or over time as they pursue a longer term de-risking strategy. Second, even though the Regulations exclude relevant insurance for assessing size criteria, they are not specifically excluded for other purposes.
Trustees subject to the new regime (and likely others given the direction of travel of TPR's Climate Change Strategy) predictably will wish to assess their new responsibilities when making decisions about a long term insurance partner under a bulk annuity transaction. Hitherto, the assessment of a suitable counterparty has inevitably focussed on price, financial security, and specific contractual terms. However, these regulatory changes open the door to a more insightful assessment of the climate-related investment strategies, and indeed more general ESG culture within long-term investment partners.

Insurers active in the bulk annuity market face two considerations. First, they should reasonably expect to have to respond to ever more probing questions from trustees about their own green credentials. Initially, this may involve presenting the insurer's own sustainability planning and internal metrics to demonstrate their progress toward implementing their own ESG standards, with some requirements to regularly report on performance to trustees. However, over time a more ambitious drive on the part of pension schemes may arise to enquire into the underlying investment portfolios backing bulk annuity liabilities, and the extent to which the schemes' assets transferred as premium will be invested in green bonds or other sustainability linked investments.

Second, insurers themselves purchase reinsurance from a range of counterparties. Structures may be funded or unfunded depending upon whether asset portfolios will be transferred to the counterparty and managed by them. Even unfunded transactions will have collateral posting obligations. Should insurers also be taking up the climate and sustainability mantle with their reinsurance counterparties? This may seem ambitious, but coheres with the role the insurance sector can play in achieving climate change goals. Whether it is achievable remains to be seen.

Clearly, 2021 is a crucial year in the industry's climate change journey. Regulators are converging and share a focus on the need for consistent ESG definitions and how to measure them. In November 2020, the UK government and UK financial regulators released a joint statement, supporting the International Financial Reporting Standards (IFRS) Foundation's proposal to create a new, global Sustainability Standards Board building on TCFD recommendations. IFRS announced creation of a working group in March 2021 and plans to propose a new set of sustainability standards by the end of September 2021 with the goal of establishing a sustainability standards board at the UN Climate Change Conference COP26 in November.

Meanwhile, corporates and pension schemes are developing their systems and controls to fully embed climate-related risks and opportunities. Whilst green bonds are coming to market and ever more ambitious structures are being developed, such assets remain scarce as market participants and regulators work towards common definitions to properly label and identify them for investors. Reinsurers in some jurisdictions, on the other hand, are less focused on climate risk strategies than others and lack clear national frameworks to help them meet the requirements of UK insurers and pension schemes. As the pace of change accelerates, however, every corner of the financial services industry will feel the impact of the climate risk mitigation measure sweeping the globe.



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