ASSET OWNERS NETWORK

CONSIDERING CLIMATE RISKS AND OPPORTUNITIES IN EMPLOYER COVENANT ASSESSMENTS

Case study: Railpen

THE PRINCE OF WALES'S CHARITABLE FUND

RAILPEN

WHAT?

The Railways Pension Scheme (RPS) is one of the UK's largest and most complex pension arrangements. Created in 1994 after the privatization of the railway industry and reorganization of the British Rail Pension Scheme, RPS has 350,000 members, holds pension assets of over £35bn, and provides pensions for over 150 sponsoring employers from different sectors of the rail industry.[1] The RPS is separated into 107 sections, each with its own valuation, balance sheet and contribution rates. For the purpose of this case study, we refer to these 107 sections as 'schemes'.

Railways Pension Trustee Company Limited (RPTCL) is the single corporate trustee board ('the Trustee'), made up of 16 trustee directors. Railpen is a wholly-owned subsidiary of RPTCL and provides the executive functions for RPS (pensions administration, communications, governance, fiduciary and investment management).

The RPS is particularly complex because of its different schemes and its 'shared cost' approach where – particularly for non-maturing schemes that remain open to new members – the sponsoring employer meets 60% of the total costs/contributions and the members meet 40%. This complexity led to Railpen setting up an in-house team of professional employer covenant advisers in 2010.

The Pensions Regulator (UK) defines the employer covenant as "the employer's legal obligation and financial ability to support their defined benefit (DB) scheme now and in the future".[2]

Our covenant team provides advice to the Trustee on the improvement, protection and monitoring of the strength of the employer covenant, in order to protect the security of RPS members' benefits. The Trustee also uses this covenant advice within its integrated risk and integrated funding decisions, ensuring that, for each pension scheme, the investment strategy and funding strategy are compatible with the covenant strength supporting the scheme.

Climate change is an important consideration in how we assess the strength of the employer covenant. It feeds into our understanding and analysis of risks and opportunities in three ways: sector-wide factors, employer governance and employer-specific details. We also use our own climate risk and net zero alignment tool, CRiANZA, to measure how closely a sponsoring employer is aligning to a net zero pathway to 2050 at the latest.

1. More information on the RPS can be found on the **Railways Pension Scheme website**
2. TPR, **Employer covenant: Overview**

WHY?

Everything we do is to make sure that members get their pensions. As climate change became more apparent as a major systemic risk, we recognized the importance of incorporating it into our employer covenant approach. For us, addressing climate risk and opportunity is essential, and is fully aligned with the Trustee's fiduciary duty.

Railways rely on assets, including long-term assets. The UK still uses tracks and bridges built in the early nineteenth century, and rolling stock can last from 20 to 40 years plus. The rail sector is also highly regulated. So the industry is vulnerable to both physical and transition risk. Adverse weather events and climate-focused regulation have already affected passenger and freight operators.

Beyond this, a poorly managed transition to net zero poses a risk to the financial system as a whole. This could affect pension scheme funding, leaving employers to cover a larger deficit and weakening the employer covenant. We need to understand and take account of that risk.

There is also opportunity from the transition to net zero. Rail is already a comparatively low-emission form of mass transport, and is a core part of the UK Government's net zero initiatives.

HOW?

Our fiduciary business unit acts as an internal client representing the Trustee, and effectively representing the members. We established the employer covenant team within this fiduciary business unit, alongside our sustainable ownership team and other specialist teams within Railpen. Structuring the teams in this way enables us to work closely with our actuarial and investment colleagues to take an integrated approach to financial and sustainability outcomes for our members, which is how we support the Trustee to meet its fiduciary duty.

This structure also facilitates a strong collaboration between the employer covenant team and the sustainable ownership team. In our employer covenant work, we draw on the practices, tools and gradings that the sustainable ownership team initially developed for our investment and asset-owning teams. We also use the sustainable ownership team's research to stay informed about what is happening in the rail industry, share information on policy statements and decisions from the government and the Department for Transport. This helps us to monitor factors that could affect covenant strength.

For us, everything comes back to longevity. We want to make sure that sponsoring employers are in a good position to meet their defined benefit pension obligations so that members' financial futures are secured. As pension scheme liabilities are long, the time frame on which we assess the employer covenant has to match that. We look at systemic risk as well as short-term financial risks – and climate change is a major systemic risk.

So climate risk and opportunity is built into our analysis at every stage. We try to identify, measure and monitor the impacts that climate change could have on a sponsoring employer and how that would affect its ability to support the pension scheme now and into the future.

When we have completed the longevity analysis for each of our schemes, we rate the longevity aspects of the employer covenant strength as either positive, neutral or negative. We review the process continually, and the following section explains the different stages of our analysis.

THE THREE STAGES OF OUR ANALYSIS

1. Sector view

Our sponsoring employers are all involved in the rail industry but come from a range of sectors, including rail infrastructure (eg Network Rail), train operating companies, train builders, rolling stock companies, freight operators, construction companies, consultancies, engineering, IT and service companies. These sectors have different characteristics, and we need to understand what they do, why they exist and how they intersect with railways.

For each sector, we look at the current position and the long-term outlook for both the sector itself, as well as the main suppliers to and customers of the sector. During this review, we take climate risk and opportunities into account. The exposure of the sector to transition risk is particularly important. To understand the nature of this risk, and how it can affect the different sectors, we work closely with the sustainable ownership team to understand any expectations for future regulation. The rail sector in the UK is already dealing with the physical impacts of climate change, with weather-related events affecting the resilience of rail infrastructure – and this is a particular focus for Network Rail.

2. Employer governance

Next, we look at the governance activities of management, including the board's oversight of climate-related risks and opportunities, as well as its role in assessing and managing these risks and opportunities. From an investment perspective, strong governance promotes and enables good long-term risk-adjusted investments.

On the employer covenant side, it gives us confidence that the sponsoring employer recognizes and manages the risks and opportunities that it faces.

Insight into governance is crucial to our understanding of the longevity aspects of strength of the employer covenant for a sponsoring employer, particularly where it has a lot of interaction with the government and public sector, which most of our employers do.

3. Employer specifics

By this point, we understand where the sector-specific physical and transition risks – as well as opportunities – lie, what the sponsoring employer's management needs to do to address this and how well-equipped it is to do so. We can then go into more detail about the sponsoring employer, including standard financial factors such as cash flows, the balance sheet and the profit and loss account. To get a more holistic view, we also consider climate risk here.

Broadly, we want to understand how the sponsoring employer is handling physical and transition risk, where it is in its own journey to net zero and whether there are any factors that could hinder it. In the same way that we look at the risks of climate change to the employer, we want to have an understanding of any related opportunities that may be sector, regional or company-specific. For example, the electrification of more rail routes and the development of battery and hydrogen tractions will benefit civil engineering, building and infrastructure, design and engineering companies.

Our CRiANZA tool enables us to measure an employer's progress against what we think it needs to do to set and achieve a 2050 net zero goal. It sets out clear expectations for each alignment status (**see diagram**). For example, an all-scope net zero ambition with medium term targets aligned with the **'Beyond Two Degrees Scenario'** would be classed as 'Committed', while short, medium and long term targets aligned with the **'Sustainable Development Scenario'** within three years would be 'Fully Aligned'.

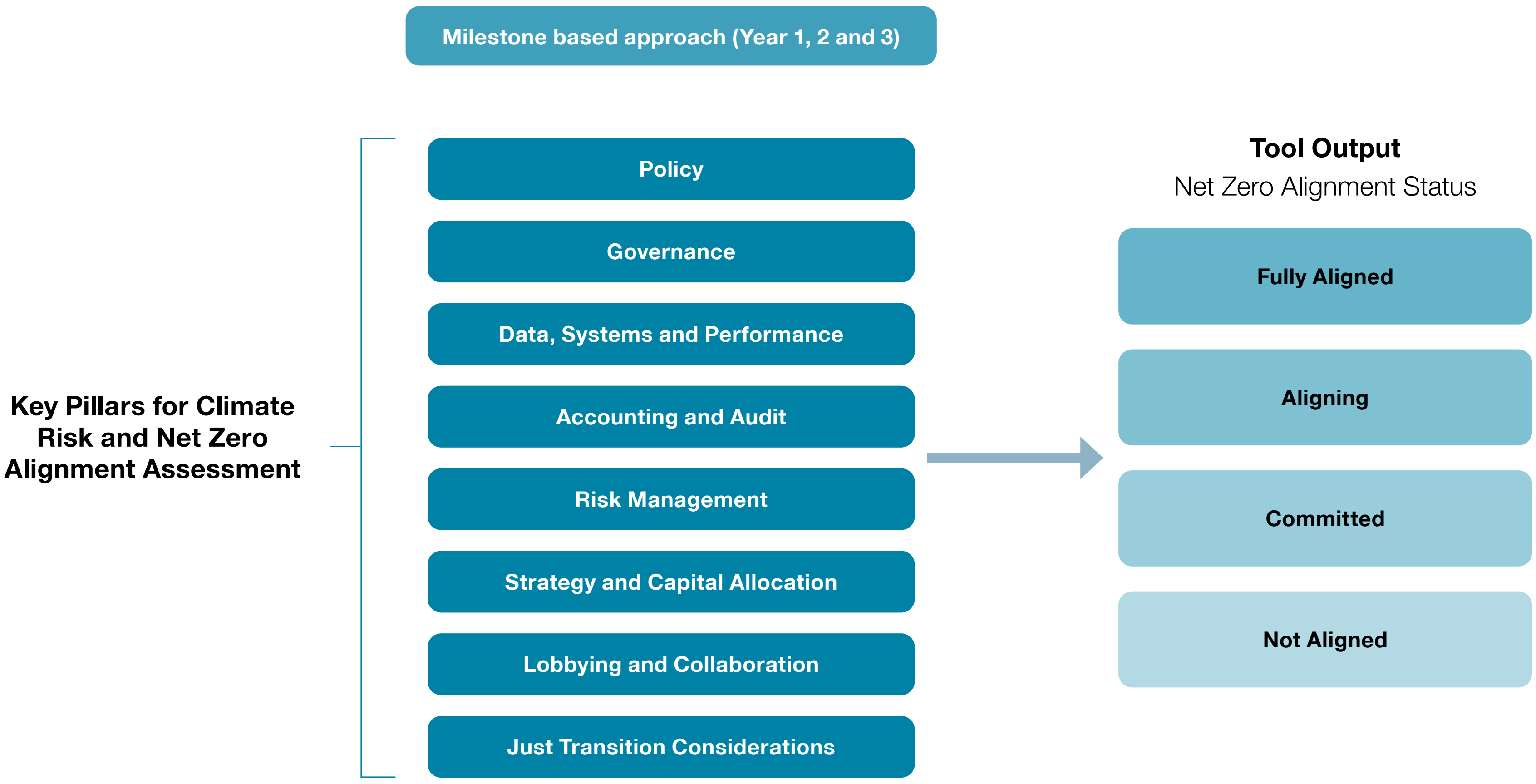

Diagram: Climate Risk and Net Zero Alignment Assessment (Source: Railpen)

THE THREE STAGES OF OUR ANALYSIS

Government policy statements and decisions give a clear indication of what actions the government would like businesses in the rail industry to take. We check a sponsoring employer's plans for addressing these policies and the impact this would have on the business and its cash flow.

One simple and tangible area we look at in our employer assessment is whether the sponsoring employer is a significant supplier to Network Rail. As part of Network Rail's commitment to reach net zero in its **Environmental Sustainability Strategy**, it set a goal for 75% of its suppliers to set their own science-based targets.[3] If the sponsoring employer is a significant supplier to Network Rail but has neither science-based targets in place nor a plan to work towards this, that is a risk. Here we would seek to influence the employer and try to put them in touch with the relevant Network Rail team and other industry bodies that could offer help and advice.

3. Science-based targets are set in line with the level of decarbonization required to keep global temperature increase below 2°C compared to pre-industrial temperatures. Information about the Science Based Targets initiative (SBTi) can be found **here.**

REPORTING TO THE TRUSTEE

Our climate risk analysis forms an important part of our overall covenant strength advice, including our view of the employer's longevity. Once we have completed our analysis, we conclude on the strength of the employer covenant. There are many factors that can impact on covenant strength, and those factors can differ for each pension scheme, depending upon its size and nature; the sponsoring employer's cash generation, liquidity and balance sheet strength; its position within the market; and its outlook. The covenant strength analysis is based on what the sponsoring employer's risk looks like right now and how much risk we think it could afford to absorb and recover from, across an appropriate timescale. We also include any realistic opportunities that might affect the business.

We then present this information to the Trustee. Over the 12 years since we formed the Railpen employer covenant team, we have worked with the Trustee to form a clear idea of what the Trustee expects and needs from us to help it make decisions. As employer covenant information is complex, we aim to make sure that our findings and advice are presented to the Trustee in a language and format that the Trustee can easily use in its decision-making processes.

Our standard reports are all prepared on a scheme-by-scheme basis and include a covenant rating rationale report. This includes a summary of scheme data such as the size of the scheme, the pension assets and funding level, and the membership profile, as well as more common covenant characteristics, so that the Trustee can easily see all the relevant information in one place. The Trustee uses this reporting in its management of the pension scheme.

We also find value in discussing the scheme's covenant characteristics – which will include material climate-related considerations – with others, including our actuarial and investment colleagues. This helps us to provide joined-up advice to the Trustee. To this effect, the covenant characteristics of the employer can influence the short, medium and long term investment strategy and objectives (its risk capacity), the funding strategy, length of recovery plans where appropriate, and the appropriate level of prudence within discount rates and technical provision.

NEXT STEPS

Our employer covenant team is now working on embedding climate risks and opportunities – as well as other environmental, social and governance (ESG) factors – into the three-year valuation process, working closely with the sustainable ownership team and our sponsoring employers.

We are aware that, while we have our CRiANZA tool, many of our sponsoring employers adopt a similar methodology. Where we can, we would like to map what employers are already doing to our work, reducing the burden on them while still being able to use a reporting framework that is familiar to the Trustee, as well as across the RPS spectrum of assets, liabilities and covenant strength.

TOP TIPS

PAY ATTENTION TO TIME HORIZONS

Pension schemes can be at different stages of maturity and therefore have different strategies, and employer covenant teams need to understand how this affects their covenant assessment.

BUILD CLIMATE RISK INTO YOUR PROCESSES

Assessing climate risk isn't a one-off. Longevity as a whole, and climate risk in particular, is dynamic. Agree a monitoring process so that you can review and update climate risk on a periodic basis. This should be underpinned by an information-sharing protocol with the sponsoring employer, so that you get information regularly.

ENSURE TRUSTEES UNDERSTAND THE IMPACT OF CLIMATE RISK

Risks that are there for the medium to long term, such as climate change, are fundamental to longevity. Trustees need to have a solid grasp on the importance of climate and other sustainability-related mega trends to their work. We expect that this is only going to become more important in future regulation.

LEARN MORE ABOUT EMBEDDING ESG CONSIDERATIONS INTO THE EMPLOYER COVENANT

There is a lot of information publicly available, including the **Employer Covenant Practitioners Association** and A4S's recently published **Top Tips for considering ESG risks and opportunities in the employer covenant process**.

MAKE SURE EMPLOYER COVENANT ADVICE IS USABLE

Employer covenant professionals must make sure that their advice is usable by the trustees they're advising. Prioritize clarity of message over getting across all the detail, even if you lose some of the subtleties. The most important thing is that the trustees get clear, actionable information that they can use in their decision-making processes.

LEVERAGE YOUR INSIGHTS TO EXPAND TO OTHER ESG-RELATED AREAS

With TCFD[4] regulation playing a key part in pension schemes' considerations, draw on your experience in identifying and applying climate-related risks and opportunities to the employer covenant process and apply this to other environment, social and governance factors.

4. **The Task Force on Climate-related Financial Disclosures (TCFD).**

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A4S ASSET OWNERS NETWORK

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