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Aligning your Pension Scheme with the TCFD Recommendations

Part I - Quick Start Guide

January 2021

The Pensions Climate Risk Industry Group

Pensions Climate Risk Industry Group

Aligning your pension scheme with the TCFD recommendations Quick Start Guide: Introduction

1.The financial Risk of climate change

All pension schemes, regardless of size, investments or their time horizons, are exposed to climate-related risks.

Distinct characteristics of climate change that require a different approach1

- **Far-reaching impact in breadth and magnitude:** climate change will affect all agents in the economy (households, businesses, governments), across all sectors and geographies. The risks will likely be correlated and, potentially aggravated by tipping points and non-linear impacts. This means the impacts could be much larger, more widespread and diverse than those of other structural changes.
- **Foreseeable nature:** while the exact outcomes, time horizon and future pathway are uncertain, there is a high degree of certainty that some combination of increasing physical and transition risks will materialise in the future.
- **Irreversibility**: the impact of climate change is determined by the concentration of greenhouse gas (GHG) emissions in the atmosphere and there is currently no mature technology to reverse the process. Above a certain threshold, scientists have shown with a high degree of confidence that climate change will have irreversible consequences on our planet, though uncertainty remains about the exact severity and time horizon.
- **Dependency on short-term actions**: the magnitude and nature of the future impacts will be determined by actions taken today, which thus need to follow a credible and forward-looking policy path. This includes actions by governments, central banks and supervisors, financial market participants, firms and households.

2. Types of climate risk

Transition risks - relates to the risks (and opportunities) from the realignment of our economic system towards low-carbon, climate-resilient and carbon-positive solutions (e.g. via regulations or market forces).

[1] HM Government: Green Finance Strategy – Transforming Finance for a Greener Future (July 2019) - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf

Physical risks - relates to the physical impacts of climate change (e.g. rising temperatures, changing rainfall, threats from rising sea levels and increased frequency and severity of extreme weather events).

3. The legal requirements on trustees to consider climate-related risks and opportunities

Fiduciary and Trust Law duties

The climate crisis poses a financial risk to all asset owners, but also presents opportunities for investors. Trustees should consider how, and to what extent, it could impact their investments and the necessary actions that arise from that assessment.

Trustees should take advice on their legal duties in the context of specific exercises of investment powers, but may wish to think in terms of three core duties when making investment decisions, as outlined below:

(A) Exercise investment powers for their proper purpose - Pension scheme trustees must exercise their investment powers for the purposes for which they were given.[2] The consideration of climate-related risks and opportunities should take place in this context.

(B) Take account of material financial factors - Trustees should always take into account any relevant matters which are financially material to their investment decision-making. These are frequently referred to as "financial factors".[3] When considering the financial implications of climate change, trustees should consider the financial implications of both transition risks and physical risks.

(C) Act in accordance with the "prudent person" principle - Trustee investment powers must be exercised with the "care, skill and diligence" that "a prudent person would exercise when dealing with investments for someone else for whom they feel morally bound to provide".[4] Standards are evolving in this area and what may be considered "prudent" in relation to climate-related risks today might no longer meet that standard in the future.

[2] Trustees should be mindful of the different duties applying to defined benefit pension schemes (where the trustee duty is to invest the scheme's assets appropriately to pay the scheme's promised benefits) and to defined contribution schemes (where the purpose of the investment power is to provide a "pot" of money to be used by each member to provide for his or her retirement).
[3] For further detail see the Law Commission's report on the Fiduciary Duties of Investment Intermediaries (July 2014) https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/
[4] Re Whiteley (1896) 33 Ch D 347 at 355

Statutory requirements

Statutory requirements apply to pension trustees in addition to their fiduciary and trusts law duties. Again, trustees should take advice on their legal obligations but should take note of the following regulatory requirements in particular:

(A) Effective system of governance including internal controls - Section 249A of the Pensions Act 2004 requires that the trustees or managers of pension schemes in scope should have "an effective system of governance including internal controls", on which The Pensions Regulator must issue a Code of Practice.[5]

(B) Disclosure of policies in the Statement of Investment Principles - The purpose of a SIP is to set out the trustees' investment strategy, including their investment objectives and the investment policies they adopt. These statutory obligations specifically require consideration of climate change.

(C) Annual Report and Accounts - Trustees should take advice on the content in relation to their particular scheme, although broadly in each annual report prepared after 1 October 2020:

- Trustees of defined benefit schemes must include a statement on how their voting and engagement policies have been implemented.
- Trustees of schemes providing defined contribution benefits are required to include a statement setting out how, and the extent to which, all policies have been implemented.

(D) Pensions Schemes Bill 2021 - Subject to consultation and approval by Parliament, the [Pension Schemes Bill 2021] will introduce new powers for Government in relation to climate change risk.

Proposed regulations[6] will apply to the largest schemes and authorised master trusts from October 2021. The trustees of schemes in scope are required to, among other things:

- implement climate change governance measures and produce a TCFD report containing associated disclosures; and
- publish their TCFD report on a publically available website, accessible free of charge.

[5] NOTE – At the time of writing the Code of Practice, has not yet been published - https://www.thepensionsregulator.gov.uk/en/document-library/statements/single-code-of-practice-statement

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

4. The TCFD Recommendations

The TCFD recommendations are structured around four thematic areas that represent core elements of how organisations operate. These might be considered to apply to pension trustees (as asset owners) as follows:

Governance - Disclose the trustees' governance around climate-related risks and opportunities

Strategy - Disclose the actual and potential impacts of climate-related risks and opportunities on the pension scheme where such information is material

Risk Management - Disclose how the trustees identify, assess, and manage climate-related risks

Metrics and Targets - Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material

HM Government

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Part II - Quick Start Guide

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The Pensions Climate Risk Industry Group

Aligning your pension scheme with the TCFD recommendations Quick Start Guide: Trustee governance, strategy and risk management: how to integrate and disclose climate-related risks

TCFD can be applied to consideration and action on climate risk at every stage of the investment journey.

1. Setting investment beliefs

When developing their investment beliefs, the trustee board should clarify their position on climate change considerations and the appropriate types of actions they might take by asset class. Under TCFD, they should formalise and document their governance policies, including roles, in relation to climate change.

2. Considering climate risks in setting investment strategies, reviewing and reporting

Trustees should consider how different investments and strategies could be impacted by transition and physical risks, at an asset class, sector and firm level where appropriate.

Schemes should set out what risks and opportunities they consider to be relevant or material to them over the short/medium/long term time horizons for their scheme. They should use scenario analysis (see module 3 and associated quick start guide) as a helpful tool.

In developing mandates and selecting pooled funds, trustees should identify strategic actions to reduce exposure to climate-related risks, as well as options for investment in climate-related opportunities.

Growth assets are more sensitive to climate-related risks than income-generating assets, but this will vary by sector and firm preparedness –some sectors (for example renewables and electric vehicles) and assets (such as green infrastructure) will benefit from the low-carbon transition.

Asset managers' climate competence should be factored into manager selection, and be monitored post-appointment. Trustees should also ensure that investment consultants demonstrate a robust track record in assessing and addressing climate risk, and have adapted their core services to include consideration and discussion of long-term risks and opportunities.

Asset managers and consultants should demonstrate consideration of climate risk management through both investment strategy and engagement. Signatory status and reporting against the Principles for Responsible Investment (PRI) and 2020 UK Stewardship Code are key minimum expectations for both managers and consultants.

Trustees should factor climate change into their monitoring and review of asset managers, by assessing performance against any climate-related objectives, benchmarks and targets, as well as the quality of voting and engagement, disclosures and scenario analysis. Trustees can use the 'Top 10' suggested questions in the Annex to rigorously assess the capabilities and approach to climate management of new and existing managers in line with TCFD recommendations.

Under TCFD, trustees should document how they identify and assess the materiality of climate-related risks and opportunities, document the main risks and opportunities for each time horizon and their potential impact, and explain their assessment of their scheme's resilience to different scenarios, including relevant metrics and targets. They should also identify, document and disclose how climate issues are included in their consultants' objectives, and in the selection, review and monitoring of asset managers.

3. Stewardship

Trustees should be clear on how stewardship fits within the scheme's investment strategy and how it helps them meet their climate-related objectives. Where they delegate to asset managers, trustees should carry out due diligence, ensure their approaches are in line with the trustees', set expectations, and hold managers to account. Where schemes carry out their own engagement, trustees should articulate clear policies and processes, making systematic use of all voting powers, and where they will support or requisition climate-related resolutions. Trustees with fewer resources for specific activities can increase their influence by joining in collaborative engagement efforts.

Trustees should document and disclose their own stewardship policies, report on how they have followed them, and hold investee companies to account on doing TCFD.

4. Additional points to consider for DB schemes

Climate change can have significant implications for the strength of the sponsor's covenant. Where sponsors are part of, or dependent on, the high-carbon economy, trustees should be aware that their scheme will likely have above-average exposure to climate-related risks. Weather-related events will affect others, for example, through impacts on supply chains or production facilities.

DB liabilities may be affected by impacts on inflation rates and demographic factors, particularly longevity. Trustees should take a holistic approach and look at how climate risks around the employer covenant, funding and investment strategy are all linked and inter-dependent, through integrated risk management (IRM).

Trustees should ask the sponsoring employer for its TCFD disclosures or equivalent information, include climate considerations in its regular covenant monitoring between valuations, and have contingency plans so they can take decisive action if and when required.

Under TCFD, trustees should identify and assess the materiality of climate-related risks and opportunities to their sponsoring employer, the main risks and opportunities for each time horizon and their assessment of their employer’s resilience to different scenarios.

5. Method of reporting and member communications

Trustees not in scope of UK regulations can include their TCFD review in the annual report and accounts, or a chair’s statement, implementation statement, or a standalone report. Those in scope must publish their TCFD report on a freely accessible public website and provide a link to it in the annual report and accounts.

Trustees can also consider including more tailored member communication on climate change in regular newsletters or social media output. There is growing evidence to show that communicating clearly with members on how climate-related risks and opportunities are being managed can also help build trust and public confidence.

Top 10 questions for Asset Managers

1. Has the manager produced a TCFD report which outlines their governance of climate related issues? (Governance)
2. Will the manager share climate-related scenario analysis undertaken as part of their investment process? (Strategy)
3. Do they support shareholder resolutions on climate change - if so, how many, which ones, and what was the rationale for their decision? (Strategy)
4. Are they transparent regarding all their voting activity? (Strategy)
5. What is the manager’s escalation policy when engagement is unsuccessful? Can they give an example of when they have escalated, how they did so, their rationale for doing so, and the outcome? (Strategy)
6. Does the manager support and/or play a leading role progressive public policy initiatives on climate change, e.g. decarbonisation of transport, agriculture? (Strategy)

7. How does the manager undertake top-down research and analysis related to climate-related risks? (Risk Management)
8. Does the manager demonstrate that the implications of climate-related risks are considered across different asset classes and investment strategies? (Risk Management)
9. Do they know, and disclose, the exposure to fossil fuel assets? (Risk Management)
10. Does the manager commit to providing trustees with appropriate (and fund specific) climate metric data required to permit the trustees to meet their own disclosure obligations? (Metrics and Targets)

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Part III - Quick Start Guide

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Aligning your pension scheme with the TCFD recommendations
Quick Start Guide: Scenario Analysis

1. Overview

Carrying out scenario analysis, which may also include stress testing of more extreme climate-related shocks, is a valuable step in trustees meeting their legal duty to manage climate-related risks, whatever the scheme's size or circumstances. This includes schemes which are planning to wind up within the next few years as climate-related shocks could still affect asset values and insurer pricing over that time period.

Scenario analysis can help test the strategic resilience of the pension scheme to different future plausible climate states.

A range of scenarios should be considered that illuminate the possible impacts of both transition and physical risks and climate-related opportunities. This could include: an orderly transition where the Paris Agreement goal is met; an abrupt transition which also meets the goal but in a sudden or disorderly way; and no transition where the world is on a pathway to 4+ºC rises by the end of the century.

Climate scenario modelling is inevitably subject to limitations due to the uncertainties and complexities involved. Trustees should not place too much weight on any single set of results, but instead use the analysis as a tool to build understanding of climate risks and make better-informed decisions.

Climate scenario analysis tools and the underlying information are evolving rapidly. Trustees should keep developments under review and consider on an annual basis whether to update their analysis.

2. Getting started

The range of tools available to help trustees is increasing fast. Light touch approaches are possible and may be appropriate for some schemes, such as smaller schemes with limited resources.

The easiest place to start is by asking your asset managers for details of any climate scenario analysis they have carried out and actions taken as a result. This is something all schemes should do. There are also free tools that trustees can use to conduct climate scenario analysis, such as PACTA and the PRA's stress test. Alternatively, you can ask your consultants or a third-party provider.

Asset managers' analysis is likely to be carried out at security level ("bottom-up") for each fund or mandate. Trustees should therefore seek ways of complementing this with consideration of scheme-level ("top-down") risks that arise from aggregation of portfolio-level impacts, macro-economic impacts and (for DB) covenant and liability impacts. It may be easiest to start with qualitative approaches that describe how climate-related impacts could crystallise over time. This should, however, be followed up with quantitative analysis as soon as practicable.

3. Minimum requirements for large schemes

Subject to consultation and approval by Parliament, regulations will come into force in October 2021 requiring trustees of schemes with net assets in excess of £1 billion, as well as authorised master trusts and schemes providing collective money purchase benefits to:

- As far as they are able, undertake scenario analysis which assesses the potential impact on the scheme's assets and liabilities of the effects of the increase in temperature and the resilience of the scheme's investment strategy and, where it has one its funding strategy, in at least two global average temperature increase scenarios, one of which must be a scenario where the increase is by a temperature between 1.5 °C and 2 °C inclusive above pre-industrial levels.
- In their annual TCFD report, describe the potential impacts on the scheme's assets and liabilities which they have identified and the resilience of the scheme's investment strategy and, in the case of DB schemes, funding strategy in at least two climate-related scenarios, including at least one scenario with an average temperature rise of between 1.5°C and 2°C inclusive

Scenario analysis must be undertaken in the first year a scheme comes into scope and every three years thereafter. However, in the intervening years, trustees must review annually whether or not circumstances have changed such that they should re-do the scenario analysis before the end of the 3-year period. If they decide not to do so, they should explain why.

These requirements indicate what could be considered **good practice** for smaller schemes.

4. Best practice

Over time, schemes should seek to address data shortcomings and modelling limitations identified in their initial rounds of climate scenario analysis. Trustees may wish to increase the sophistication and granularity of their modelling, incorporating the latest thinking from across the industry. They may find it helpful to compare results from several different models and increase the number of scenarios considered.

5. Reporting

When disclosing details of the climate scenario analysis they have carried out, trustees should include:

- Details of the scenarios used, methodology and related assumptions;
- The external factors which have limited their ability to do scenario analysis, such as data gaps, and the steps they are taking to address these; and
- Their conclusions regarding the strategic resilience of the scheme and the actions they have taken as a result.

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Aligning your Pension Scheme with the TCFD Recommendations

Part IV - Quick Start Guide

January 2021

The Pensions Climate Risk Industry Group

Pensions Climate Risk Industry Group

Aligning your pension scheme with the TCFD recommendations Quick Start Guide: Setting metrics and targets to measure and manage climate-related risk

1. Role of Metrics

Metrics and targets have a key role to play in activities throughout the pension scheme's investment decision-making process, not only in measuring their risk exposure (outcome metrics), but also in managing their climate risk exposure (process metrics).

It is important that the metrics incorporated by the trustees are chosen according to their relevance to the scheme.

2. Availability of Data

The lack of available data is a commonly reported pitfall when schemes seek to calculate the TCFD's recommended metrics. Few, if any, trustees will be able to obtain full underlying data across their entire portfolio in the first instance. There are a number of ways in which trustees can compensate for this issue to ensure their metrics are decision useful:

- Where gaps in data do exist trustees could use modelling or estimation to fill them. Trustees may do this by utilising proxy data where direct measurement is not possible. For example, where you cannot find data for a specific asset or asset class it may be possible to acquire averages for the sector they sit in and make estimations based on that.
- Where incomplete data-sets exist for quantitative metrics, qualitative metrics may be used for analysis instead (or as well).
- If the company or asset manager does not report energy use and emissions data for its operations or a particular fund, trustees could use third-party data providers.
- Trustees may also choose to only report metrics and targets, or perform scenario analysis, for the sections of their portfolio for which reliable data can be found.

3. Selecting Metrics

The level of greenhouse gas (GHG) emissions is one key outcome metric by which pension schemes can measure their transition risk, as well as being the most straightforward.

Care is needed where data is not standardised – some firms quote only scope 1 (direct emissions) and 2 (indirect emissions from producing the electricity used); others also estimate scope 3 (all other indirect emissions).

However, firms with similar carbon intensities today can have divergent future trajectories.

Other metrics include Forward-looking outcome metrics such as “implied temperature rise” can be used to estimate that trajectory.; and process metrics such as shares of portfolio in which climate engagement is carried out, or for which acceptable quality data has been obtained.

Core Outcome Metrics

Carbon Footprint – measures how many tonnes of CO_2e emissions each million (£m) invested funds.

$$\frac{\sum \frac{current\ value\ of\ investment}{enterprise\ value\ including\ cash} \times\ issuer'scope\ 1,2\ \&\ 3\ GHG\ emissions}{current\ portfolio\ value\ (£M)}$$

- Can use to compare asset classes/portfolios to one another or to a benchmark
- Using the portfolio market value to ‘normalise’ data is intuitive to investors

WACI – metric for measuring a fund’s exposure to carbon intensive assets

$$\sum_{n}^{i} \left(\frac{current\ value\ of\ investment_i}{current\ portfolio\ value} * \frac{company'GHG\ emissions}{company's\ £M\ revenue_i} \right)$$

- Fairly easy to communicate to trustee board and members

Total Carbon Emissions – measures the total absolute greenhouse gas emissions attributable to a portfolio.

$$\sum_{n}^{i} \left(\frac{current\ value\ of\ investment_i}{Enterprise\ Value\ Including\ Cash\ _i} * issuer's\ Scope\ \ 1,2\ \&\ 3\ GHG\ emissions_i \right)$$

- Simple to calculate and easier to track progress
- Enables trustees to set a baseline for climate action and to understand the climate impact of their investments

Implied temperature rise – forward-looking metric of future emissions, expressed as a projected increase in global average temperature.

- Provides forward looking measure – where investments will transition to, rather than where they are now
- Expressed in easy to understand single temperature unit or range

Core Process Metrics:

Share of portfolio held at year end for which engagement or voting on climate-related risk and opportunities has been a substantive topic

- Does not require complex data, useful for monitoring asset managers

Share of portfolio held at year end for which climate-related metrics of an acceptable quality have been obtained

- Very simple to understand
- Focuses trustee attention on improving data quality as part of asset manager appointment and monitoring decisions.

4. Targets

Once metrics have been established, TCFD recommends the setting of targets. These can be outcomes-based targets, such as a reduced portfolio carbon intensity; or process-based targets around data, engagement and voting.

Target-setting is a useful tool for trustee boards to track their efforts to reduce climate change risk exposure and maximise climate change investment opportunities. Targets should be embedded in governance processes, so that trustees can hold managers and consultants to account for performance against their prescribed objectives.

5. Examples of Targets

The targets trustees set should be useful and relevant to their scheme. Trustees should ensure they are measurable and be sufficiently stretching. The following are some examples of targets Trustees may wish to set:

Starting out

- Percentage of shareholder resolutions on climate related risk the scheme or persons representing the scheme support.
- Number of conversations/engagements between pension scheme and its asset managers analysing/discussing their voting on ESG matters.

Good Practice

- A reduction in the average carbon footprint of your investment portfolio
- A reduction in the implied temperature rise of your portfolio

Best Practice

- A reduction in the carbon intensity or WACI of your portfolio or of a particular asset class / sector represented in their portfolio.
- A X% reduction in the total absolute greenhouse gas emissions attributable to your investment portfolio