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The tip of the iceberg: exploring TCFD regulations

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Environmental, social and corporate governance (ESG) and climate change remain under the spotlight for pension schemes and continue to be a key focus for trustees. A raft of new climate reporting obligations were introduced this year under the Pension Schemes Act 2021. The new requirements are being phased in, with larger schemes whose net assets are £5bn or more and master trusts to comply from 1 October 2021. Schemes with £1bn or more of assets will be in scope from 1 October 2022. Trustees of schemes in scope will be required to put in place appropriate governance arrangements to manage climate-related risks during the first scheme year in which the regulations first apply to them and then to produce and publish a report on how they have done so (the Report) within 7 months of their scheme year end date.

Background

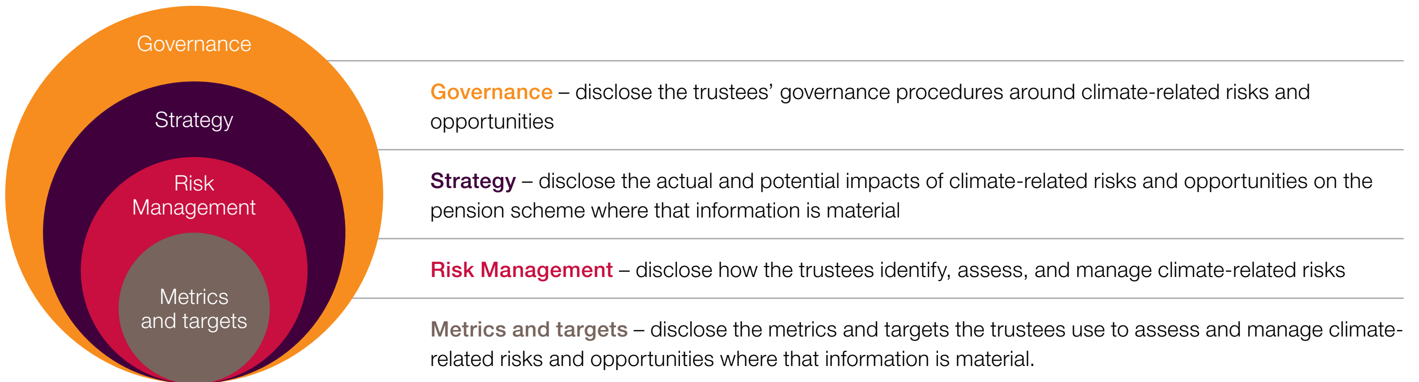
As ESG related matters have risen in prominence, the consideration of climate related issues has become part and parcel of trustees' trusts law and regulatory duties. In 2017, the Taskforce on Climate-related Financial Disclosures's (TCFD) recommendations established a set of 11 "clear, comparable, and consistent" disclosures through which an organisation might identify, manage and disclose its exposure to climate-related financial risks and opportunities. Building on this work, in July 2019, the Government set out its expectation in its Green Finance Strategy for all listed companies and large asset owners to make climate-related disclosures in line with those TCFD recommendations. Making good on this expectation, the Pension Schemes Act 2021 provides regulation-making powers that can be used to mandate such reporting by pension schemes, requiring trustees to carry out associated governance actions.

On the 8 June 2021, the Department for Work and Pensions (DWP) published its response to its January consultation "Taking action on climate risk: improving governance and reporting by Occupational Pension Schemes" together with revised draft regulations and draft statutory guidance. The final regulations were approved by parliament in July 2021 and are due to come into force on 1 October 2021. The regulations are accompanied by statutory guidance also published by the DWP. In addition, to help trustees consider what actions would be appropriate in their own scheme's circumstances, the PCRIG has published voluntary, non-statutory guidance for trustees on the integration of climate risk into decision-making. Sackers is proud to have led the development of this cross-industry guidance.

In practice, meaningful disclosures on climate will not be possible without trustees undertaking certain governance activities, and for the first time the regulations not only tell affected trustees what they must disclose on ESG matters, but also prescribe specific actions that must be taken first.

TCFD recommendations

The TCFD recommendations can be considered in four areas, as applicable, to pension trustees as follows:



Governance – disclose the trustees' governance procedures around climate-related risks and opportunities

Strategy – disclose the actual and potential impacts of climate-related risks and opportunities on the pension scheme where that information is material

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

Metrics and targets – disclose the metrics and targets the trustees use to assess and manage climate-related risks and opportunities where that information is material.

Although the TCFD recommendations focus on "disclosures" by organisations, the framework is fundamentally a useful tool for pension trustees in assessing the relevance of climate change and managing any consequences.

Requirements under the regulations

Governance

- Trustees of schemes in scope must establish and maintain, on an ongoing basis, oversight of the climate-related risks and opportunities which are relevant to the scheme.
- Trustees must also establish and maintain processes for the purpose of satisfying themselves that persons undertaking governance activities on their behalf are taking adequate steps to identify, assess and manage any climate-related risks and opportunities which are relevant to the governance activities they are undertaking, and that persons who advise or assist the trustees with respect to governance activities are taking adequate steps to identify and assess climate-related risks and opportunities.

The first step in implementing TCFD recommendations is for trustees to ensure climate-related risks and opportunities are integral to their usual governance procedures. Not only should this make it easier to comply with disclosure requirements when they begin to bite, but it will help to provide a sound framework around which investment decisions can be made. In practice, much of the management of climate-related risks will be delegated to investment managers by many trustees. Trustees must think about how they provide oversight and review of activities so delegated.

Strategy

- Trustees of schemes in scope must identify the climate-related risks and opportunities which they consider will have an effect on the scheme's investment strategy (and funding strategy where applicable) and assess their impact.
- Trustees are required to identify these risks and opportunities and their impact over the short, medium and long term.

Considering climate change as part of a scheme strategy will involve considering how climate-related issues might impact the scheme's investment portfolios (including the default fund(s) in a DC scheme) and, in a DB scheme, its funding strategy and employer covenant.

Scenario analysis

- Trustees of schemes in scope must, as far as they are able, undertake scenario analysis assessing the impact on the scheme's assets and liabilities, the resilience of the scheme's

investment strategy and (where it has one) the scheme's funding strategy for at least two scenarios – one of which corresponds to a global average temperature rise of between 1.5 and 2°C inclusive on pre-industrial levels.

- Scenario analysis must be carried out in the first year in which the requirements apply to the scheme, and at least every three years thereafter. Whenever trustees undertake fresh scenario analysis, the triennial cycle is automatically reset. Where a scheme has both DB and DC sections, separate scenario analysis will be required for both the DB section(s) and the DC default fund(s).

Scenario analysis is a well-established tool for understanding possible alternative futures and developing strategic plans that are more flexible or robust to a range of plausible future states. Pension schemes can use scenario analysis to assess their scheme's resilience to climate related risks and opportunities. Trustees will need to discuss with their advisers the scope of scenario analysis they intend to undertake, which parts of the scheme it will apply to and who is going to carry it out. It will be important to start early in order to ensure that the work can be completed before the end of the first scheme year. Trustees may also wish to use the results of their scenario analysis to better inform their scheme strategy (see above).

Risk management

- Trustees of schemes in scope must establish and maintain, on an ongoing basis, processes for identifying, assessing and effectively managing climate-related risks which are relevant to the scheme and integrate them into the trustees' overall risk management of the scheme.
- They should then describe the processes they have established in their TCFD report and how these are integrated within the overall risk management of the scheme.

Trustees should always take into account any relevant matters which are financially material to their investment decision making. This may well be about whether a particular factor is likely to contribute positively or negatively to anticipated returns. But, it may equally be about whether a factor will increase or reduce risk. Trustees will need to think about how both the physical risks of climate change and the transition to a low carbon economy might impact their investments, funding and sponsor covenant and ensure that these are suitably integrated into their risk management procedures including the scheme's risk register and integrated risk management (IRM) approach.

Metrics and targets

- Trustees of schemes in scope must select and report on at least three climate-related metrics for each of a scheme's DB sections and popular DC arrangements as follows:
    1. one "absolute emissions" metric – the statutory guidance recommends total GHG emissions of the portfolio
    2. one "emissions intensity" metric – the statutory guidance recommends tonnes of GHG emissions for each million (£m) of the scheme's assets
    3. one "additional" climate change metric – the statutory guidance provides a range of options (see below).
- Trustees will be required, "as far as they are able", to use total emissions and carbon footprint metrics – calculating Scope 1 and 2 GHG emissions in the first scheme year they are subject to the requirements, and then Scope 1, 2 and 3 in all subsequent years (see further below).
- If trustees use a different absolute emissions or emissions metrics from those in the statutory guidance, they should explain why.
- Trustees must set a non-binding target for the scheme in relation to at least one of their chosen metrics and, as far as they are able, measure performance against it on an annual basis.

Disclosing emissions and other climate-related metrics is a key element of the new regulations and is likely to be the aspect of compliance that will take the most preparation. Trustees should allow themselves plenty of time to undertake training on the different metrics, engage with their managers

to understand the data available (and crucially what might not be) and then consider what the most appropriate metrics for their scheme might be. Targets will also require careful thought. Contrary to popular belief the regulations do not necessarily require net zero or other emissions reduction targets to be set, although many trustees will wish to do this. Trustees should consider what target setting will best help them manage the climate-related risks and opportunities pertinent to their scheme and remain ever-mindful of the need for these to align with their overriding duty to provide members' pensions. Having said that, trustees should not be surprised if members and civil society groups use a scheme's disclosures on metrics and targets as a yardstick to judge their climate performance.

Top tips for trustees

Governance	• Allow appropriate time and ongoing training to ensure sufficient understanding of climate issues. • Consider the roles and responsibilities within the trustee board for climate related issues. • Consider how processes for the selection, review and monitoring of the scheme's asset managers takes account of climate change issues. • Consider recording governance structures in a climate policy or governance framework document in order to evidence approach from 1 October.
Strategy and Scenario analysis	• Undertake scenario analysis in the first scheme year in which the regulations apply (for schemes with a 31 December year end, this might mean that scenario analysis has to be carried out within three months of the regulations applying). • Ensure sufficient time is allowed for training to understand the models used and be clear on its application for each "sectionalised" section in a DB scheme and for each "popular" arrangement in a DC scheme. • When implementing a scheme's investment strategy, asset managers should be assessed on the extent to which they address climate risk and take advantage of related opportunities. • Where stewardship activities are delegated to asset managers, trustees should familiarise themselves with the managers' stewardship policies in relation to climate-related issues, ensure these are in line with trustees' climate-related investment beliefs, and hold their managers to account in relation to their engagement activities and voting record on climate issues.
Risk management	• Revisit risk registers and add climate-related risks as a consideration. • Consider risks in both scheme's investments and (in the case of DB schemes) funding and sponsor covenant. • Consider how often to revisit the assessment of climate-related risks.
Metrics and targets	• Emissions-based metrics provide some visibility into the past carbon exposure of assets at a fixed point in time but may provide little insight into possible future exposure. Trustees may wish to consider the limitations and backward looking nature of such metrics. • Metrics chosen should be those helpful when making informed decisions about financial risks and opportunities in portfolios. Trustees should take care not to get carried away with metrics and target setting for its own sake.

Timings

Trustees of schemes with relevant assets (net assets excluding bulk annuity and individual annuity contracts) ≥£5bn at the end of their first scheme year to fall on or after 1 March 2020:

- must meet the climate change governance requirements for the current scheme year from 1 October 2021 to the end of that scheme year
- must publish the Report on a publicly available website within 7 months of the end of that scheme year, and a link must be included in the Annual Report and Accounts for that scheme.

For schemes with relevant assets ≥£1bn at the above requirements apply one year later.

Trustees will be required to provide the Pensions Regulator, via the scheme return, with the website address(es) for their most recent Report, their SIP, implementation statement and relevant excerpts of the Chair's statement (as applicable).

Timeline for compliance

The new obligations come hot on the heels of the requirements introduced last year for schemes to produce annual implementation statements, with most schemes producing their first statements during the spring / summer of 2021.

The reporting deadlines for both implementation statements and climate reporting requirements are dictated by scheme year ends but operate slightly differently in each case. The various timings can be somewhat confusing. Please see our Guide for a series of timelines for DB and DC schemes of different sizes and with scheme year ends of either 31 December or 31 March.

With the deadline of 1 October 2021 for schemes whose net assets are £5billion or more fast approaching, such schemes should now be well prepared to meet the disclosure and reporting obligations. Mid-sized schemes whose net assets are £1 billion or more should also now be gearing up to be compliant by 1 October 2022. As discussed above, the regulations not only set out what trustees of schemes in scope must disclose, but also prescribe specific actions that must be undertaken first. Trustees of mid-sized schemes should be starting to consider these actions now and making sure that climate-related risks and opportunities are integral to their usual governance procedures.

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