From https://www.gov.uk/government/consultations/aligning-your-pension-scheme-with-the-tcfd-recommendations/tcfd-for-trustees-of-pension-schemes-quick-start-guide

Appendix B

Why is climate change important for pension schemes?

Climate change is both a financial risk and an opportunity for pension schemes like any other risk such as interest rates, exchange rates, inflation, company performance and the economic cycle. It is not just an ethical, moral or quality of life issue.
All pension schemes experience climate risk through the impact on scheme assets – felt by members of Defined Contribution (DC) schemes and sponsors of Defined Benefit (DB) schemes. DB schemes will also see an impact on the strength of the employer covenant, member longevity, interest rates and inflation.

Transition risks

Transition risks are risks from the realignment of our economic system towards low-carbon, climate-resilient or carbon-positive solutions.

Physical risks

Physical risks relate to the impacts of climate change, such as rising temperatures, changing rainfall, flooding risk and extreme weather.

Transition and physical risks are both short-term and longer-term risks – relevant for the vast majority of schemes' time horizons.

Trustees' legal duties

Trustees have a fiduciary duty of undivided loyalty to the best interests of members, which is normally interpreted as delivering an appropriate financial return. As such, they have a legal duty to consider matters which are financially material to their investment decision making.

Trustees also have a statutory duty to document their policies on material financial considerations including climate change, and to document and report on their policies in relation to investor engagement and voting. Government has tabled an amendment to the current Pension Schemes Bill to take powers to mandate TCFD-aligned disclosures.

What is TCFD and how can it help?

Published in 2017, the Taskforce on Climate-related Financial Disclosure (TCFD)'s recommendations establish a set of 11 clear, comparable and consistent disclosures about the risks and opportunities presented by climate change. The recommendations are intended to be used by everyone in their mainstream financial filings – public and private companies, asset managers, insurers and asset owners, including pension schemes.

The process of carrying out TCFD reporting is intended to lead to better-informed decision-making on climate risks, and the improved transparency is intended to

improve accountability and provide decision-useful information to investors and ultimately beneficiaries.

TCFD in the investment cycle

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, trustees should clarify their position on climate change considerations, their beliefs on the extent of asset mispricing 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. They should use scenario analysis (see page 3) 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 indicators. 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.

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. 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 climate-related resolutions.

Under TCFD, 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, on 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 should incorporate the outcome of their TCFD review into the scheme's annual report and accounts, or a chair's statement, implementation statement, or a standalone report.
Communicating clearly with members on how climate-related risks and opportunities are being managed can also help build trust and public confidence.

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Specific aspects of TCFD reporting

Scenario analysis

Scenario analysis is a helpful technique for assessing their resilience to different future outcomes. This helps trustees assess how assets (and, for DB schemes, their liabilities) may be affected by different outcomes.
The PCRIG guidance recommends 3 scenarios:

- orderly transition, 2ºC or lower scenario [significant transition risks, lower physical risks] – emission reductions start now and continue in line with the Paris Agreement
- abrupt transition, 2ºC or lower scenario [severe transition risks, lower physical risks] – little climate action in short term, followed by sudden unanticipated tightening as countries rush to get on track
- no transition, pathway to 4+ºC scenario [no transition, severe physical risks] – continuation of historic emission trends and failure to transition away from fossil fuels

Tools are available from a number of providers – both paid for and free – showing how portfolio valuations (and, in some cases, DB liabilities) may be affected.

Trustees can:

- ask their asset managers for the results of their own scenario analysis – take care when aggregating across managers, as the assumptions may differ
- ask their consultant or a third party provider – more firms are now offering a range of climate scenario analysis services
- do it themselves – the free Transition Pathway Initiative tool rates the carbon management quality and carbon performance of companies within high risk sectors. The free PACTA tool shows the extent to which the firms in high risk sectors are aligned with given climate scenarios. The illustrative Bank of England data in Appendix 3 also suggests how different sectors may be affected by the low carbon transition.

Metrics and targets

Metrics and targets have a key role to play in activities throughout the pension scheme's investment decision-making process, both in managing their climate risk exposure (process metrics) and in measuring their risk exposure (outcome metrics).
Weighted average carbon intensity takes the current carbon emissions per unit of revenue, for each company in the portfolio, and weights these by their share of the portfolio. It can be used for equity and fixed income assets. 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 recommended metrics include outcome metrics such as exposure to carbon-related assets, funds invested in low carbon opportunities; and process metrics such as share of board meetings given to climate risk, and shares of portfolio in which climate engagement is carried out, or acceptable quality data has been obtained.

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Finally, TCFD recommends the setting of targets. These can be both process-based targets around investment, engagement and voting, and outcomes-based targets such as a reduced portfolio carbon intensity or a higher proportion of holdings in better prepared companies.

5 easy steps to get started

1. Check you've got the governance and risk management right – develop and document your investment beliefs. Formalise and document your governance policies, including job roles, in relation to climate change.
2. Integrate into your investment and funding strategies – document the main climate risks and opportunities which will affect your scheme and their possible or likely impact. Explain how you will both mitigate those risks and take advantage of the opportunities. For DB, include climate change in covenant assessment and monitoring.
3. Ask your consultants and asset managers to demonstrate climate competence. Make your expectations, drawn from your beliefs and strategies, clear. Both providers should demonstrate signatory status in relation to the PRI and UK Stewardship Code, a robust track record on climate, and consideration of climate risk as a core service. Trustees should assess new managers on the quality of voting and engagement, and the quality of disclosures and scenario analysis, and monitor existing firms on their performance against any climate-related objectives, benchmarks and targets. Don't be afraid dig deeper and keep asking questions. Challenge what you hear.
4. Conduct scenario analysis – Analyse your own holdings, for example using the TPI and PACTA tools. Compare your findings with peers. Challenge your asset managers and advisers on the results.
5. Monitor metrics – Ask your asset managers to report on the weighted average carbon intensity of your portfolio and compare this with similar products. Challenge your managers on what they are doing to engage with or reduce exposure to the most-polluting firms, getting data where it is unavailable,