XPS Investment

Climate Change Reporting

What pension schemes can learn from the first wave of TCFD reports

November 2022

Contents

Climate change is now widely accepted as being a critical aspect of investment management, and the TCFD reporting requirements aim to help schemes better understand their climate change risk exposure.

In this report Alex Quant discusses how the first wave of larger schemes have reported so far, and what other schemes can learn going forward.

Summary observations and next steps for schemes

We have analysed the Taskforce for Climate Related Financial Disclosure ('TCFD') reports of 12 large pension schemes who had produced reports up to 30 September 2022, in order to understand any trends or consistent areas of challenge with the new reporting requirements.

This covers c.£320bn of assets under management. This is not an exhaustive list of the TCFD reports available but should serve as a useful indication of how schemes have gone about TCFD.

In summary, we find the following key observations:

- **There was consistent setting of strategy and targets linked to Net Zero and Paris Agreement** – 11 out of 12 schemes set a Net Zero target by 2050 or sooner, with all but one of these setting an interim target to get there. This is encouraging and necessary for the pension scheme industry to effectively contribute to the global effort to avert the significant global impacts of climate change, as well as ensuring the schemes' portfolios are well positioned to deliver their objectives through the transition to a low carbon economy.
- **Many schemes reported positive performance outcomes in an Orderly Transition scenario where they had incorporated climate change explicitly into their strategy** – By contrast there was a consistent pattern of worst performance outcomes expected in a Failed Transition scenario (where climate change is incorporated in a shorter space of time), with some schemes reporting significant falls in long term funding and/or asset performance.
- **Room for improvement on carbon emissions reporting** – Listed equity and credit continue to have highest levels of coverage, with many schemes choosing only to report carbon data on this portion of their assets. Only 3 schemes included any Scope 3 reporting (i.e. indirect value chain emissions). This is largely reflective of current limited data availability, but needs to improve in order to support effective decision making and monitoring of Net Zero targets.
- **Focus appears to be on invested assets, with less detail provided on the implications for liabilities or covenant risk** – This is understandable as arguably the assets are where key aspects of risk sit, and where progress has been made. However, the reporting requirements do extend to liabilities and sponsor covenant so we expect development of reporting, analysis and assessment of risks in these areas.

Next steps for pension schemes

It's clear that undertaking the analysis and reporting required by TCFD is beneficial for schemes in understanding their climate change risk exposures, so they can better address these challenges in their investment strategy. For schemes that will be reporting for the first time, it's important to start planning for their TCFD disclosures and engaging with their advisers accordingly if they haven't already.

For small schemes not yet subject to the strict requirements, we believe there are still merits in taking time to understand their climate change risk exposure, including assessing the current carbon footprint of the scheme. There are a growing number of climate-aligned investment products available which allow all schemes to better manage climate risks and access opportunities associated with the carbon transition.

Schemes should start planning for next years' TCFD disclosures by engaging with their managers and advisors early, and drawing on the learnings from this first wave of reports.

Alex Quant
Investment Consultant &
Head of ESG Research

Introduction and background

Climate change is a systemic issue which will require significant policy response and structural economic and societal changes in order to mitigate a global disaster.

This presents real risks within financial markets to pension schemes who do not address these issues and take them into account in their management of the scheme. It also presents opportunities for schemes to take advantage of evolving trends which support a future low carbon economy; a Bloomberg report earlier in the year predicted that in order to deliver successful climate transition investments, up to $4.2 Trillion would be required per year by 2030 (which isn't a long timeframe). These risks have implications for invested assets, liabilities, sponsor covenant, as well as having implications for member preferences.

As a result, climate change reporting requirements were brought in for pension schemes in 2021, with requirement to report using the TCFD framework. Overall, TCFD reporting aims to support schemes in better understanding and managing these climate change and opportunities.

Schemes with assets greater than £5bn were required to be compliant from 1 October 2021, and produce a TCFD report within 7 months of the subsequent scheme year end. Schemes with assets greater than £1bn are required to be compliant from 1 October 2022. For schemes with assets less than £1bn, we are expecting clarity in 2023 over how the requirements will extend to them.

Summary of TCFD requirements

The reporting framework covers 4 pillars – **Governance**, **Strategy**, **Risk Management** and **Metrics and Targets** – and each pillar has specific disclosure requirements, which are set out in detail in the main body of this report. However, taking a step back from the detailed disclosures, the framework requires schemes to:

1

Establish **governance framework** for managing risks

2

Describe and identify **key risks and opportunities**

3

Undertake **scenario analysis** to understand **resilience of portfolio** to future states

4

Select metrics

Set targets against metrics

5

Take steps to **mitigate risks** and **take advantage of opportunities**

In the following sections we discuss each aspect of the reporting requirements, summarising what the requirements are and setting out our key observations from the scheme TCFD reports so far.

Governance

The Governance and Risk Management sections were, as expected, broadly descriptive and focus on the processes that schemes have in place to ensure climate change is fully addressed.

Requirements

Under the requirements of 'Governance', schemes are required to:

- Incorporate management of climate risk into ongoing governance arrangements.
- Ensure oversight of parties that undertake climate risk management on your behalf (e.g. asset managers).

Observations from reports

Most schemes commented on the following aspects to introduce climate change into their governance framework:

- **Responsibility:** In most cases this was delegated by the Board to the investment sub-committee. Two schemes established specific committees relating to climate change / Net Zero strategy.
- **Trustee beliefs:** Nearly all schemes indicated that they had spent time defining their preferences and priorities to inform the approach.
- **Policy and objectives:** At a minimum, schemes need to cover climate change in their Statement of Investment Principles. 9 out of 12 indicated that they had gone further and established bespoke Responsible Investment / Climate Change Policies.
- **Training:** All schemes described training received in the year on ESG and climate change to ensure those responsible have a sound understanding of the issues in question. We noted some schemes received training on a wider range of topics including biodiversity.
- **Consultation on climate capabilities of advisers:** Many schemes listed their advisers and service providers in relation to climate change, and some provided detail on the assessment of their respective capabilities to evidence that there was appropriate oversight of risks.

Governance in summary

Schemes should proactively ensure that climate change is part of the ongoing agenda for managing the pension scheme. It's important to undertake training so the relevant decision makers understand the issues. Reviewing the trustee board beliefs and priorities is an important second step as this will inform future actions.

Risk Management

Within Risk Management schemes built on the overall framework described in Governance and detailed the steps taken in the year to help identify risks and opportunities, with the best reports providing clear examples to evidence the risk management in practice.

Requirements

Under 'Risk Management' the requirements are for schemes to explain the process for identifying risks, the process for managing risks, and the process for integrating management of climate change risks into the overall risk management framework.

Observations from reports

We observed consistent themes for identification of risks, including establishing a risk committee or 'climate working party' – we do not expect all schemes to need to do this, but it could be considered to ensure dedicated consideration of climate change. Most schemes explained the policies and processes for identifying risk, which often included:

- Requesting reporting from managers and advisers;
- Engage and discuss with managers and advisers; and
- Inclusion of climate change in the risk register.

In terms of then managing the risks, many schemes were clear in linking management of risks to their investment strategy, for example describing changes to strategic allocation, implementation and engagement undertaken to address risk areas. There was a clear link here to the Strategy section (see below).

In our view, the best reporting provided case studies of engagement with managers or companies, or tangible changes to the investment strategy which clearly demonstrated management of risks.

Risk Management in summary

The reports indicated schemes making good progress to identify and address climate risks. In general, many of the existing risk management practices have been extended to include climate change, so this is now part of 'business as usual' scheme management – this approach is likely to work well for schemes who are thinking about climate change for the first time and can keep this as a recurring agenda item to consider.

As described further in Strategy below, when it comes to actually managing climate change risks, may schemes implemented changes within their investment approach. In terms of reporting, providing examples of the changes or engagement with existing investments is a good way of demonstrating risk management.

Strategy

The majority of schemes set an overall Net Zero strategy. There was mixed level of detail provided in terms of the action being taken to deliver the objective, but in general the impacts on strategy entailed updates to investment allocations, targeted engagement as well as application of exclusions to the portfolio.

The results of scenario modelling indicated that schemes who had made climate-aware changes to their investment strategy might expect better outcomes under a successful transition scenario.

Requirements

Under 'Strategy' schemes are required to:

- Set out the climate-related risks and opportunities they have identified
- Define time periods for evaluating climate risks
- Describe impact of climate risks on strategy, and implementation
- Undertake scenario modelling and describe resilience of scheme to climate scenarios

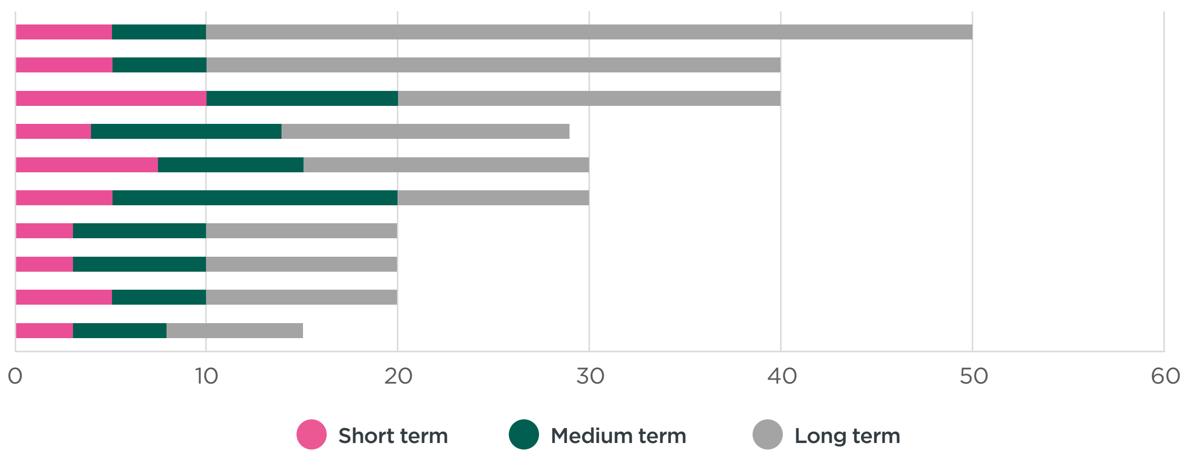
Observations from reports

Time periods varied and were linked to broader objectives of scheme

In the reporting so far, all schemes were clear on the time periods defined for considering climate change. It was clear that the time periods set were very scheme-specific, and therefore varied, often linked to broader objectives of schemes. Some common determinants of the time period set were:

- **Short:** Linked to triennial valuation, or where the scheme felt they had good visibility on the covenant strength.
- **Medium:** Aligned to their de-risking pathway, or the point at which they would achieve low reliance on sponsor.
- **Long time periods:** Defined based on the point at which long-term journey achieved, or in many cases linked to Net Zero objective (2050).

Time periods set by schemes (years)



Source: XPS survey of TCFD reports

Majority set strategy linked to Net Zero

In terms of the impact on broader strategy, all schemes were clear that meeting benefit payments was primary objective. The vast majority then set overall strategy to address climate change which was linked to Net Zero and the Paris Agreement – only 1 scheme did not indicate that they had a Net Zero strategy.

The reporting indicated how climate change considerations had affected the schemes' funding strategies, and what schemes were doing to enhance the climate change credentials of their portfolio.

There were some common pillars to the approach:

1
Use of sustainable funds

Climate aware investment solutions – Schemes described switching into new pooled funds or updating existing segregated mandates to incorporate climate-aligned objectives, often with an explicit Net Zero target as part of fund objective.

XPS research indicates that these are increasingly available across most asset classes, however many schemes did recognise the challenge of fully embedding climate considerations across their portfolio.

2
Exclusions

Common exclusions mentioned were thermal coal and tar sands.

It was encouraging to see several schemes note that exclusions would be applied at a minimum to exclude only the worst offenders – e.g. those exposed to climate transition with no plans to improve.

3
Engagement

Almost all reports described engagement with managers as key to achieving the overall strategy.

Some schemes provided examples from underlying companies to demonstrate improved outcomes.

Less focus given to liabilities and covenant risk

The TCFD requirements are clear that resiliency of the funding strategy includes consideration of liabilities and the strength of the covenant.

We found it was more common for a qualitative approach on liabilities. A common theme was many schemes noting that interest rates and inflation risks were well hedged. Limited sophisticated analysis on longevity impacts and this is an are we expect to develop quickly as a key source of climate risk on the liability side.

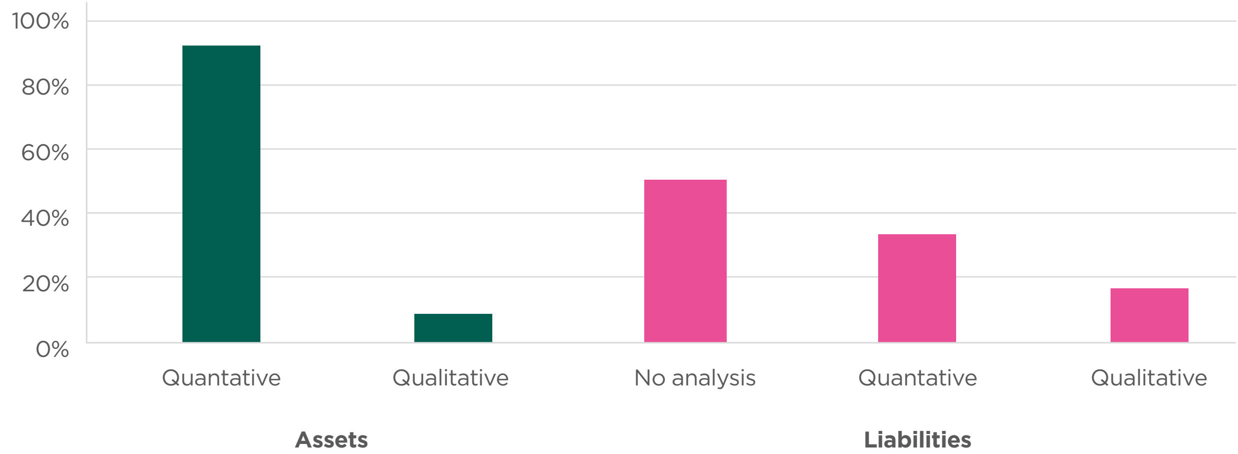
Furthermore, there was often lack of detail provided on covenant exposure to climate risks. It's clear that the regulatory direction of travel will affect an increasing number of companies. Therefore, it's critical that schemes have a clear view on the climate risks and management of those risks by their sponsor.

Majority use quantitative approach to modelling but limited disclosure on liabilities

Scenario modelling is a key requirement to demonstrate resilience of scheme to future climate states. Trustees asked to consider at least two future climate scenarios, including one aligned to 2°C or lower.

The guidance suggests that both qualitative (describe what the impacts could be based on expected economic outcomes), or quantitative (modelling / stress testing of impacts on portfolios and funding) approaches are acceptable.

Quantative or qualitative scenario analysis



Source: XPS Survey of TCFD Reports

We observed the majority of schemes undertook quantitative analysis utilising specialist external providers, although some took a qualitative approach for assessing the impact on liabilities. In some cases, it was clear that quantitative analysis had been undertaken, but the reporting was limited to a reference comment – this provides little insight for the reader.

Climate-aware strategies expected to see improved outcomes in successful transition

All schemes were compliant with requirement to analyse at least 2 scenarios. We noted a wide range of analysis conducted and scenarios considered – but all broadly spanned the spectrum of 'orderly transition' (2°C) through to 'failed transition' (>4°C) outcome.

We've summarised some consistent observations across the schemes' reporting:

- Some schemes noted positive expected performance outcomes in an orderly transition vs the base case scenario – often this was where steps had been taken to enhance the climate-awareness of the investment strategy.
- The expected outcomes in terms of funding level / asset performance were projected to be worse under a 'Disorderly' or 'Failed' transition.
- Many schemes noted shocks to funding level or asset valuation in the medium term under disorderly transition as a result of asset re-pricing / political intervention in the next 5-10 years.

Fund management industry modelling capability developing but progress and consistency needed

For schemes looking to undertake scenario analysis in the future, our survey of fund managers shows the capability of most managers is growing here, so that they can provide investors with the analysis required for their funds. This does raise challenges around aggregation and comparison for the scheme as a whole.

You can read more about our insights on the climate change and ESG capabilities of fund managers here.

It's important for small schemes to bear in mind that a qualitative approach is still acceptable but may not provide the greatest insight to decision makers, therefore schemes should consult on their advisers' capabilities, and consider the cost-benefit of utilising a specialist provider if needed.

Strategy in summary

The majority of schemes set an overall strategy linked to Net Zero, and described changes to their investment approach to support achieving that outcome. We encourage all schemes to consider whether an overall Net Zero strategy is suitable in the context of the broader objectives; there are a number of climate-aware investment solutions available for all scheme circumstances. We expect modelling of climate risk to become more prevalent even for schemes not subject to TCFD requirements.

Metrics

The metrics provided were for the most part consistent with the recommended disclosures from the DWP. Coverage of emissions data varied significantly, with most schemes only reporting Scope 1 and 2 emissions date, and many only disclosing for certain portions of their assets (often only listed equity and credit where data is more readily available).

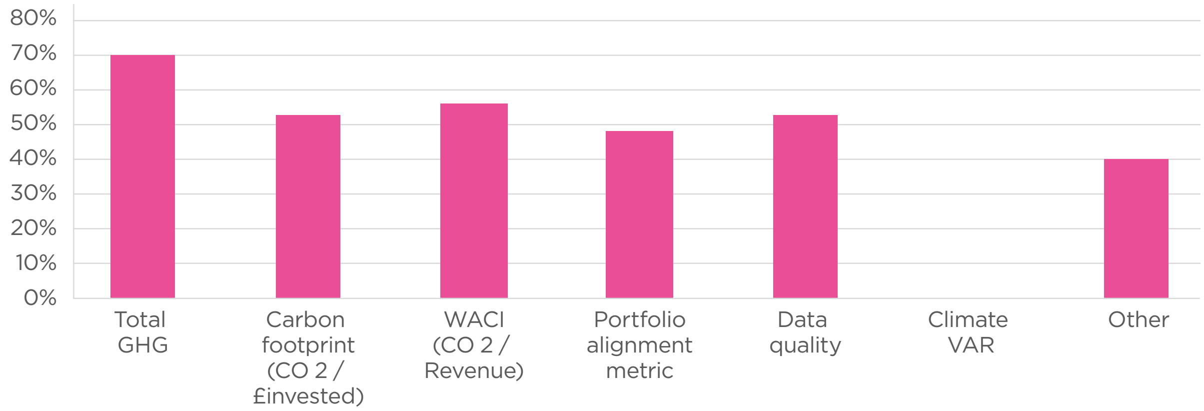
Requirements

Under the Metrics section schemes are required to select at least four metrics: two emissions-based metrics (one absolute measure and one intensity measure); one 'other' metric, and a 'Transition Alignment' metric – the requirement for which was introduced in June 2022.

Observations from reports

Perhaps unsurprisingly, the recommended emissions metrics from the DWP were most prevalent (total absolute emissions and an emissions intensity metric), with 'data quality' the next most common metric.

% schemes selecting climate metrics



Source: XPS Survey of Investment Managers

A transition alignment metric was only included by a few schemes, so this will need to change now that this metric has become a requirement.

Where 'Other' metrics were used, these were commonly relating to engagement on climate change, and also proportion of portfolio exposed to certain harmful activities.

Climate Value at Risk was one of the alternative measures put forward by the DWP, yet no schemes analysed elected to report this measure.

Only one scheme illustrated their chosen metrics going back over previous years.

Schemes should focus on forward looking metrics, and the introduction of the transition alignment metric requirement will help this.

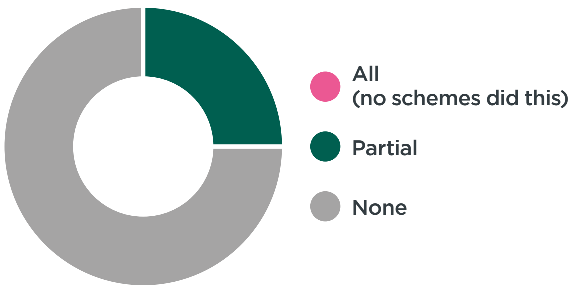
Expect gaps in data, and be ready to explain

Coverage of carbon data was mixed across the reports, and within reports there was a clear pattern of better disclosure on listed equity and credit.

For the 12 reports surveyed many schemes reported only on a certain portion of their assets, ignoring for example alternative asset classes or gilt-based allocations. Where coverage was disclosed, this was on average 71% for Scope 1 and 2 and 40% for Scope 3.

There was a lack of consistent reporting on Scope 3 emissions; only 3 reports provided any data on Scope 3. This is unsurprising as Scope 3 is regarded as being more challenging to measure. However, importantly we found a lack of 'comply or explain' in relation to Scope 3, which is expected under the reporting requirements. An FCA report on companies' TCFD reports flagged this issue, and so we expect similar feedback for pension schemes.

% schemes disclosing Scope 3

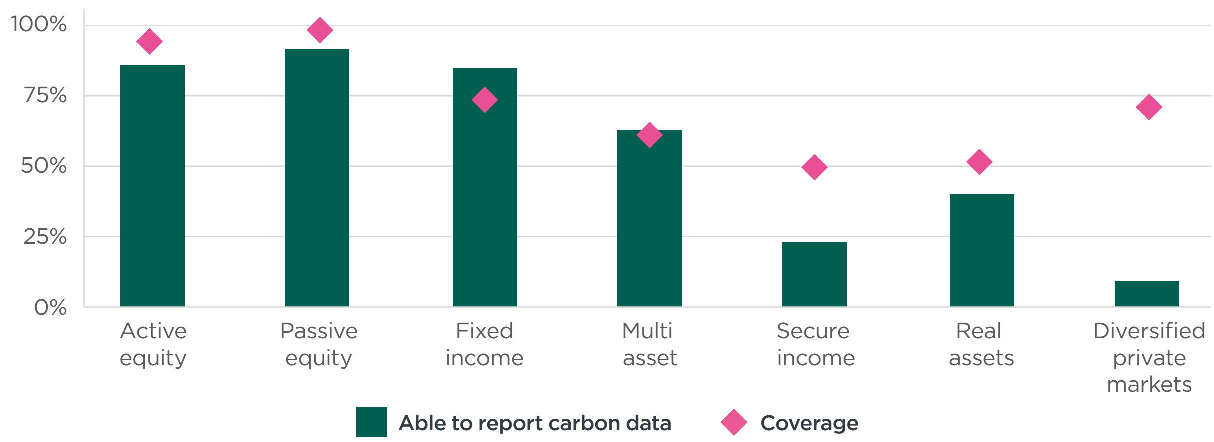


Source: XPS Survey of TCFD Reports

Looking forward to future reporting, schemes should expect gaps in data and be ready to explain them, for example coverage varies significantly by asset class and in particular it is clear Scope 3 carbon emissions are still growing in availability. Remember the requirement across TCFD is to report "as far as you are able" – don't let perfect get in the way of good.

In line with the reporting observed, our wider research of 255 funds across 63 managers indicates that availability of carbon data is highest for listed equity and fixed income, with greater focus needed by managers in other asset classes to provide their investors with the information needed.

Provision of carbon data across asset classes



Source: XPS Survey of Investment Managers

Metrics in summary

It's clear certain metrics are emerging as market standard, notably Weighted Average Carbon Intensity, and whilst coverage is clearly mixed across schemes and asset classes, we expect this to grow over time. Schemes should be sure to focus on forward-looking metrics as well as backward looking emissions data, and the introduction of the transition alignment metric requirement will help this. Schemes should engage with their managers and advisers early to understand what metrics are available so they can plan to explain gaps in data and any volatility in the numbers over time.

Targets

Following on from the Strategy section, the majority of schemes set targets on their carbon emissions linked to delivering their Net Zero strategy. Some schemes included other targets around data quality and engagement.

Requirements

Majority set Net Zero carbon emissions targets

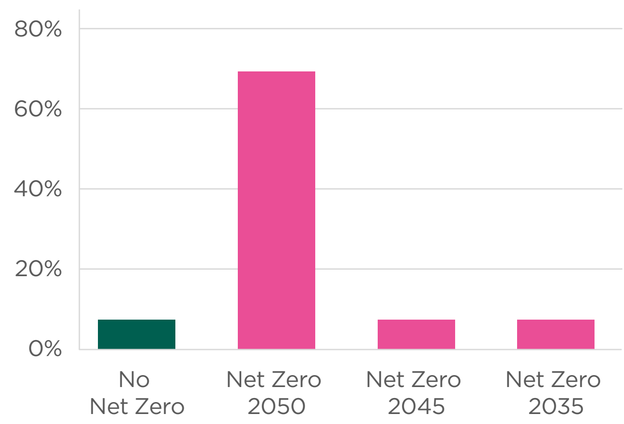
The final aspect of the TCFD reporting requirements is to set a target for one of the selected metrics, and annually measure the scheme's performance against that target. Targets should be based on recognised metrics, be quantified and granular, and have a clear baseline and timeframe.

Observations from reports

Where schemes have set a target against their chosen metrics, nearly all set a Net Zero carbon emissions target, usually by 2050 with some targeting 2035 or 2045.

For the schemes who had set a Net Zero target, every scheme except one had an interim target. It's critical that schemes setting Net Zero targets give consideration to the pathway over time towards Net Zero to ensure the overall target is robust. Furthermore, we're clear that a Net Zero target needs to be accompanied be consideration of forward-looking climate transition alignment, so that the focus is not only on reducing emissions. You can read more about our thoughts on pension schemes setting Net Zero targets here.

Schemes setting Net Zero targets



Source: XPS Survey of TCFD reports

Where other targets have been set these tended to relate to:

- **Data quality** – targeting improvement in coverage of emissions data over time.
- **Engagement** – number of engagements or proportion of portfolio engaged with on climate issues increasing over time.

Schemes should be aware of the flexibility within the regulations around target setting (targets can be set for certain asset classes, or only a portion of the scheme assets). We noted a few schemes who set their Net Zero targets for a particular portion of their portfolio – for example only the listed equity holdings. Whilst this is aligned to the regulations, there will be an expectation that the scope of the target increases over time.

Targets in summary

It's clear the majority of targets set to date are in relation to emissions data linked to the overall Net Zero target. We would encourage schemes to think about adding targets relating to transition alignment too, as well as ensuring long-term targets are supported by shorter-term interim targets to track progress.

Next steps and how we can help

While the prospect of TCFD can be daunting for many schemes, the experience so far suggests schemes are meeting the requirements, but also more importantly that the analysis is helping to support decision making in the long-term interest of the schemes' outcomes.

Early engagement with your investment consultant and/or investment managers around how they can support your scheme is an important first step.

For a pension scheme wishing to meet the reporting requirements of TCFD, or simply wanting to understand and enhance their approach towards climate change, we think the following steps are a good start.

Next steps for pension schemes

1. **Undertake training:** As required to cement understanding of key issues.
2. **Discuss and establish beliefs:** Integration of climate change can mean different things to different people.
3. **Use this to inform objective setting and policy:** This sets the framework for discussion and decision making.
4. **Engage with key stakeholders:** Including pensions and investment consultants, covenant advisor, investment managers and sponsor.
5. **Review existing arrangements:** Ask your investment consultant to review the climate change credentials of your existing investment managers, including your carbon footprint.
6. **Consider sustainable funds:** Look at ways to enhance the climate change alignment of your investment strategy to better manage risks and take advantage of opportunities.

If you'd like to speak to us about how we can help your scheme meet the TCFD reporting requirements, or assess the climate risk exposure of your scheme even if you're not yet subject to the TCFD requirements, please get in touch with Alex Quant or speak to your usual XPS contact.

About us

XPS Pensions Group is a leading pensions consulting and administration business fully focussed on UK pension schemes. XPS combines expertise, insight and technology to address the needs of over 1,500 pension schemes and their sponsoring employers on an ongoing and project basis. We undertake pensions administration for over one million members and provide advisory services to schemes and corporate sponsors in respect of schemes of all sizes, including 51 with assets over £1bn.

XPS Investment provides clear and independent investment advice that can be quickly and effectively implemented. We advise pension schemes and their corporate sponsors and have over £113bn of assets under advice.

Simeon Willis
Chief Investment Officer
t 020 3967 3895
e simeon.willis@xpsgroup.com

Alex Quant
Head of ESG Research
t 020 8059 7652
e alex.quant@xpsgroup.com

Award winning

Pensions advisory

Professional Pensions UK Pensions Awards 2022 — WINNER — Actuarial/Pensions Consultancy of the Year — XPS Pensions Group

Professional Pensions UK Pensions Awards 2021 — WINNER — Actuarial/Pensions Consultancy of the Year — XPS Pensions Group

Professional Pensions UK Pensions Awards 2019 — WINNER — Actuarial/Pensions Consultancy of the Year

Administration

Professional Pensions UK Pensions Awards 2022 — WINNER — Third-Party Administrator of the Year — XPS Pensions Group

Professional Pensions UK Pensions Awards 2020 — WINNER — Third-Party Administrator of the Year — XPS Pensions Group

Professional Pensions UK Pensions Awards 2019 — WINNER — Third Party Administrator of the Year

Investment consulting

Professional Pensions UK Pensions Awards 2022 — WINNER — Investment Consultancy of the Year — XPS Pensions Group

Professional Pensions UK Pensions Awards 2021 — WINNER — Investment Consultancy of the Year — XPS Pensions Group

Technology

Professional Pensions UK Pensions Awards 2022 — HIGHLY COMMENDED — Technology Innovation of the Year — XPS Pensions Group

Pensions Expert Pension and Investment Provider Awards 2020 — Winner — Technology Services of the Year — XPS Pensions Group

Culture and Sustainability

Business Culture Awards 2020 — Gold Overall Winner

UK Employee Experience Awards 2020 — Gold Award Winner — Employee Engagement

UK Employee Experience Awards 2020 — Silver Award Winner — Employee-centric Company

UK Stewardship Code

Important information: Please note the opinions expressed herein do not take into account the circumstances of individual pension funds and accordingly may not be suitable for your fund. The information expressed is provided in good faith and has been prepared using sources considered to be reasonable and appropriate. While information from third parties is believed to be reliable, no representations, guarantees or warranties are made as to the accuracy of information presented, and no responsibility or liability can be accepted for any error, omission or inaccuracy in respect of this. This document may also include our views and expectations, which cannot be taken as fact. The value of investments and the income from them can go down as well as up as a result of market and currency fluctuations and investors may not get back the amount invested. Past performance is not necessarily a guide to future returns. The views set out in this document are intentionally broad market views and are not intended to constitute investment advice as they do not take into account any client's particular circumstances.

Please note that all material produced by XPS Investments is directed at, and intended solely for the consideration of, professional clients within the meaning of the Financial Services and Markets Act 2000 (FSMA). Retail or other clients must not place any reliance upon the contents. This document should not be distributed to any third parties and is not intended to, and must not, be relied upon by them. Unauthorised copying of this document is prohibited.

This document should not be distributed to any third parties and is not intended to, and must not be, relied upon by them. Unauthorised copying of this document is prohibited.