XPS Investment

Net zero targets are common, but many lack a clear strategy

TCFD in review — year 2

December 2023

Contents

Executive Summary

The Task Force on Climate-related Financial Disclosure (TCFD) framework aims to improve reporting and drive action to address climate risks, as well as steering entities into opportunities associated with climate change.

Mandatory TCFD reporting was introduced for the largest pension schemes in 2021, making 2022 the second year it has applied. This report is our second review of a sample of TCFD reports where we summarise the key trends and learnings for schemes going forward.

The 28th Climate Change Conference of Parties, or COP28, is taking place in December 2023, with new global commitments on a range of issues expected. Furthermore, in the UK the FCA has just published its final policy on Sustainable Disclosure Requirements furthering the UK Government's Roadmap to Sustainable Investing. Therefore, it's clear that the importance of focusing on climate change and sustainability for pension schemes and other investors is only going to increase.

Summary observations

1

60% of schemes have a Net Zero target, largest schemes account for the majority of action

83% of £5bn+ schemes set a Net Zero target, compared to only 35% of £1bn+ schemes. Amongst the £5bn+ schemes setting a target, in our view 73% had a clear plan to achieve the objective, compared to only 17% the £1bn+ group.

Work is needed to ensure all schemes have a robust strategy, with focus on transition alignment (beyond just carbon reduction) and on engagement to deliver the objective.

We calculated a weighted average of reported Implied Temperature Rise of 2.8°C, indicating schemes are holding assets which are misaligned with the climate transition.

2

Schemes are making meaningful changes to strategy

We see it that reporting is the first step to successfully managing climate risks, and is leading to constructive discussions rather than detracting from more action being taken.

Most £5bn+ schemes indicated that they had introduced climate-aware funds (**67%**) and were directly financing climate solutions (**61%**). However, most £1bn+ schemes had not taken action in their portfolios and indicated a greater reliance on engagement to address risks.

3

Many schemes report missing targets

44% of £5bn+ schemes indicated that they had missed or were not on track to meet the targets they had set last year. Volatility in metrics is expected, so schemes should take time to understand sources of underperformance and what can be done to address this.

4

Scenario modelling may not lead to meaningful conclusions

The schemes that carried out scenario modelling reached a wide range of different conclusions: **63%** concluding that a failed climate transition led to the best outcome for the scheme, while **37%** found that an orderly transition would provide the best outcome. Schemes also reported that the scenario modelling was incomplete or not representative, and schemes generally did not report that the scenario modelling had led to any meaningful conclusions on strategy or any changes to strategy.

5

Areas of non-compliance highlighted by TPR are still being missed

The Pensions Regulator (TPR) identified a number of areas where they felt schemes were not compliant for the year 2021-22. Our assessment shows that on some key aspects some schemes are still falling short in 2022-23. For example, only **57%** provided any direct commentary on broader funding strategy beyond investments.

Actions for schemes

- In advance of next year's reporting, spend time engaging with managers on what they are doing within their mandates to deliver the scheme targets that have been set.
- Work with managers and advisors to get a more complete sense of transition alignment, where coverage so far is patchy. Most schemes have made good progress accessing data on emissions, but embedding forward-looking alignment to the Paris Agreement in manager investment guidelines is critical.
- Consider switching into climate-aware versions of existing investment strategies that can deliver your financial objectives and have meaningful sustainability benefits.
- Consider how scenario modelling can be made more effective, e.g. considering more granular, short-term scenarios and how these may impact scheme decision-making.

Some schemes have made good progress to address climate risks in their portfolios, but the majority must place more focus on transition alignment in order to contribute to real world change.

Alex Quant
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Head of ESG Research

Introduction

2023 provided the hottest summer on record, with average land and sea temperatures soaring above historical averages. It's clear that climate change, and inter-related impacts on nature and biodiversity, are leading to the loss of value of companies all over the world right now – research by Boston Consulting Group concluded the decline in ecosystem functionality is costing the global economy more than $5 trillion a year in the form of lost natural services).

The UK Government has scaled back on many of its climate commitments, issuing new oil and gas licenses and delaying the ban on petrol and diesel cars. However, looking past these announcements, **at a global level policy intervention is moving us in the right direction**. The International Energy Agency released a report which indicated that global emissions may peak as soon as 2023, with newly implemented policies and growth in low carbon technology leading to lower emissions and global temperature projections than was thought likely even just a year or two ago. Yet the report warns that **current policies remain far from sufficient to limit warming to 1.5°C**.

Therefore, it's critical that governments and corporates continue to address this systemic issue, and **investors must consider their exposure to climate risks and position their portfolios to prosper and contribute to a low carbon future** in the coming years.

Overview of TCFD requirements and our analysis

The reporting framework covers 4 pillars – **Governance**, **Strategy**, **Risk Management** and **Metrics and Targets**. 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 this report we present analysis across a sample of 35 pension scheme TCFD reports, where the reports were readily available:

		# Schemes	AUM (£)
Schemes £5bn+ (Wave 1)	TCFD required from Oct 2021 Second reports in 2023	18	£313bn
Schemes £1bn+ (Wave 2)	TCFD required from Oct 2022 First reports in 2023	17	£36bn

1. How TCFD is shaping strategy

Net Zero is commonplace for £5bn+ schemes, but strategy not always well defined

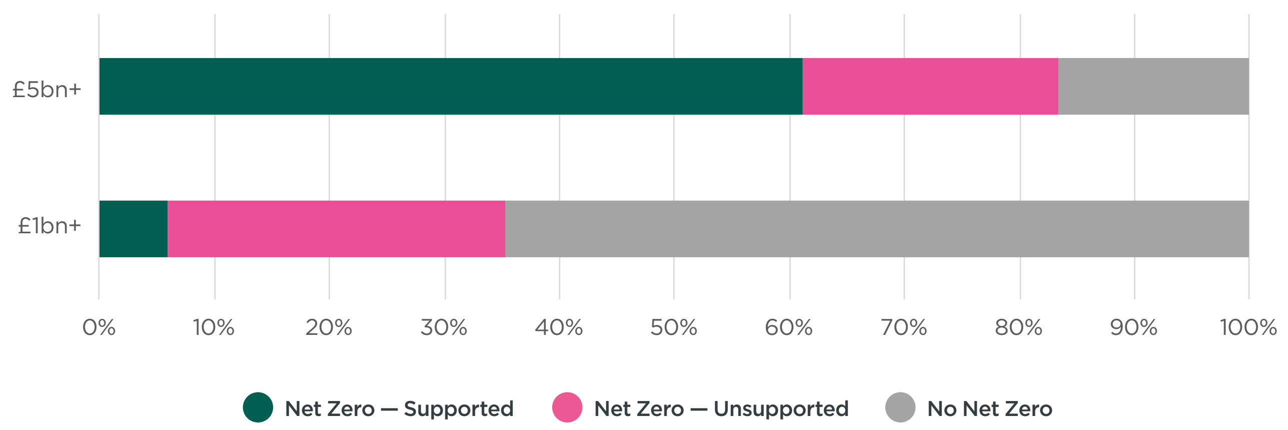
The vast majority of £5bn+ schemes we reviewed stated an objective to achieve Net Zero, most commonly by 2050 (two £5bn+ schemes set more ambitious targets of 2045 and 2035). On the face of it this widespread take-up is good, as this should steer investment towards companies and investments which support delivery of the Paris Agreement.

However, when reviewing the Net Zero strategies described, we found that in many cases these were not robust: **83%** of £5bn+ schemes set a Net Zero target, but in our view **27%** of those did not provide evidence of being supported by a clear strategy (for example aligned to the IIGCC framework – see below). **35%** of £1bn+ schemes had set a Net Zero target. As discussed in Section 3, targets on data quality or engagement were more popular with £1bn+ schemes.

The Institutional Investors Group on Climate Change (IIGCC) has a framework for helping investors set an effective Net Zero strategy. The key aspects they reference are decarbonisation, investment in climate solutions and engagement with highest emitters.

Therefore, when reviewing the robustness of a scheme's Net Zero strategy we were looking to see a combination of: interim targets across key metrics; focus on transition alignment as well as emissions reduction; descriptions of a clear plan and what levers the trustees were going to use to achieve the strategy; and/or evidence of action already taken to date within the assets (for example switching implementation into funds with climate objectives in the mandate). Loose reference to an 'ambition' to align to Net Zero, without an indication of what would be done to achieve it, was not deemed robust.

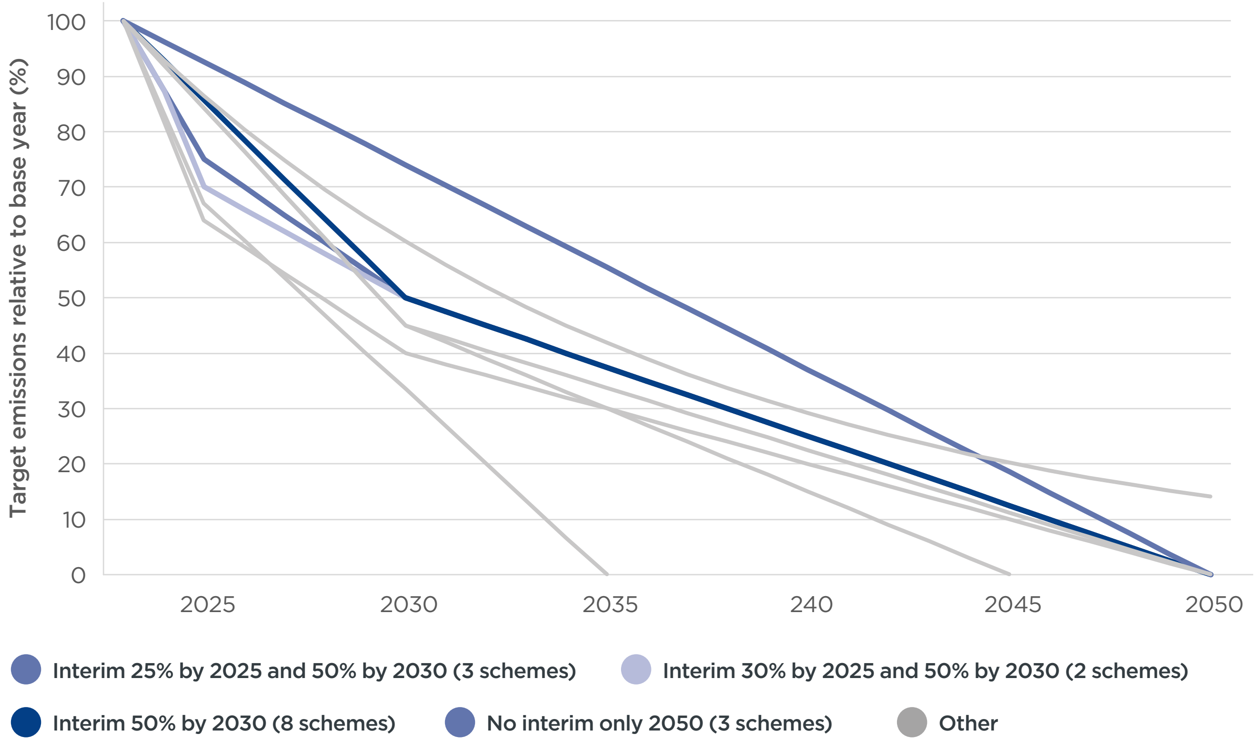
Proportion of schemes with a Net Zero objective



Source: XPS review of publicly available TCFD reports

An interim target is an important aspect to prompt short-term action. We saw **86%** of all schemes that set a Net Zero target had articulated an interim target. **38%** of schemes set a 2025 interim target, and **81%** set a milestone for 2030. One scheme stated the objective was to reduce emissions by 7% per annum, i.e. annual targets. The chart below illustrates the various carbon reduction pathways schemes have put in place.

Schemes set a range of carbon reduction pathways



Source: XPS review of publicly available TCFD reports

Schemes are making portfolio changes in response to climate assessment

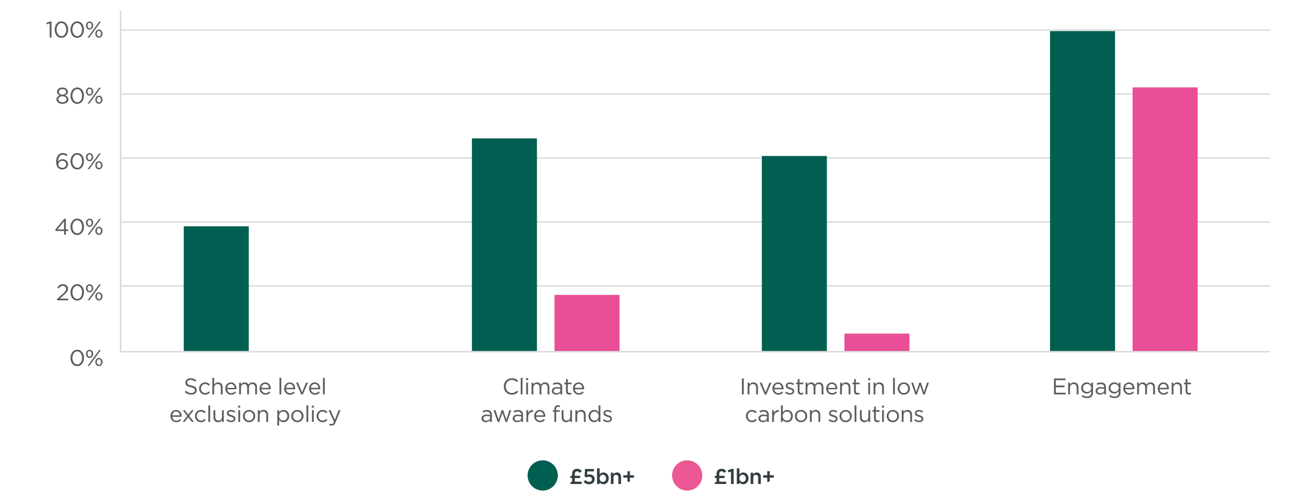
One of the criticisms levelled at schemes and TCFD following the first round of reporting was that, due to the onerous nature of the reporting requirements – collecting data, calculating metrics, etc – the requirements have not led to meaningful outcomes or changes by schemes.

TPR commented that ***"trustees will have spent significant time and effort calculating and disclosing emissions data. This may have restricted the time available for trustees to interpret and take action on the data, as some reports put less emphasis on these aspects."***

However, we see it that reporting is the first step to successfully managing these risks and is not in our view detracting from more action being taken. Our analysis this year indicates that £5bn+ schemes do seem to have made progress in this regard, with most indicating that they had made changes within their portfolios to bring climate-aware objectives into their mandates and directly finance climate solutions. However, £1bn+ schemes indicated a greater reliance on engagement, or more fundamental reliance on 'integration' of climate analysis within existing mandates rather than direct action.

The chart below summarises the approaches taken by schemes to address risks posed by climate change aligned to their overall climate strategy.

Approaches taken within investments to address climate risks



Source: XPS review of publicly available TCFD reports

With the first year of reporting out of the way we expect £1bn+ schemes to consider the growing range of investment solutions available across all asset classes to switch the implementation of their strategy into funds which can deliver the schemes' financial objectives whilst better managing climate risks.

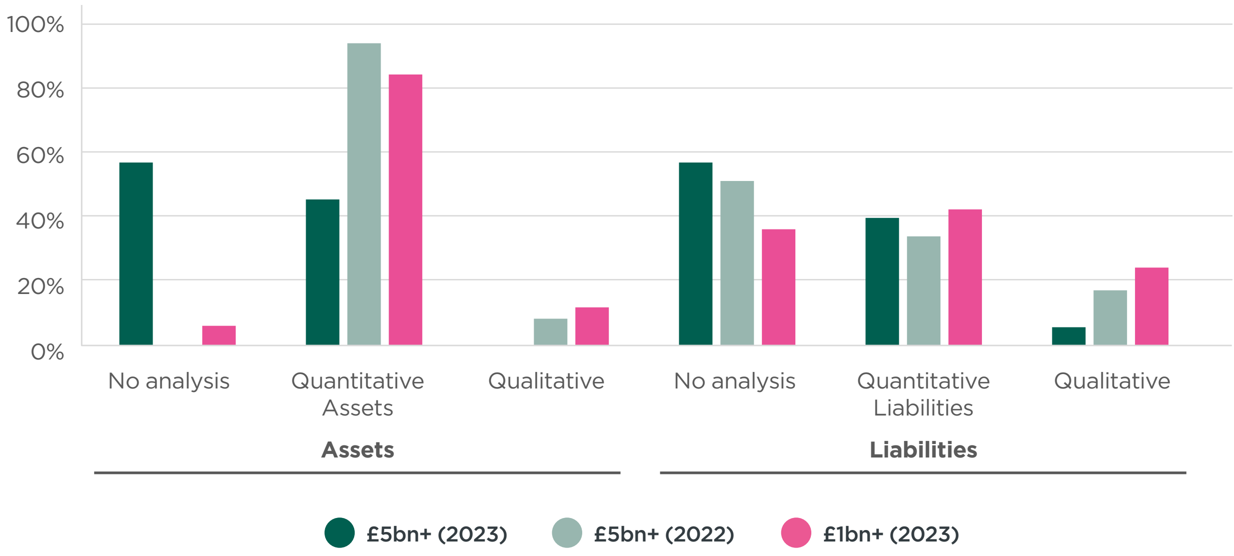
Scenario analysis remains an area of development

There have been wide-spread discussions concerning the credibility of stress testing being undertaken by investors under various climate scenarios. Well-recognised shortcomings have been highlighted particularly in relation to the modest apparent financial impacts of physical risks in a high global warming scenario. Therefore it's pleasing to see work being undertaken to enhance the analysis available – for example, the collaboration between USS and the University of Exeter creating new scenarios that focus on the shorter-term (**source**).

Given TCFD only requires schemes to undertake scenario analysis every 3 years, we saw **56%** of £5bn+ schemes chose not to undertake analysis again in the second year's report. Fairly consistent rationale for this decision was provided across schemes, with most reasoning that there had been no material changes to the strategy, or no material changes to the quality of the analysis available.

For those schemes that did undertake scenario analysis the vast majority took a quantitative approach to model their assets, although this year more schemes also took a quantitative approach in analysing their liabilities. We noted one £1bn+ scheme that did not do any scenario modelling in the reporting year, therefore were non-compliant (the scheme noted they were going to undertake the modelling in the coming year).

Quantitative or qualitative scenario analysis



Source: XPS review of publicly available TCFD reports

We noted that the majority of schemes continue to include an orderly 1.5°C scenario in their analysis. This is useful to frame the results of the other scenarios, but it will be interesting to see the use of this scenario going forward as slow global progress makes an orderly transition increasingly unrealistic.

There was wide variation in the conclusions from the scenario analysis, reflecting the range of approaches taken and the difficulty of drawing robust conclusions from the very long-term and high-level scenarios that many schemes are using. For example, **63%** reported that the scheme fared best under a failed transition or 'hot house world' scenario, whereas **37%** of schemes concluded that an orderly transition would provide the best outcomes for the scheme. The number of schemes that concluded that a failed transition was the 'least worst' scenario may reflect the fact that the worst climate and financial outcomes are projected to occur many years in the future, and the effect of discounting these impacts back to the present day minimised their apparent effects.

We observed many schemes commenting that their strategies are expected to be resilient to the risks after looking at scenario analysis. This was often due to the liability hedging in place and the expectation that schemes would de-risk before the climate impacts might materialise. A number of schemes commented that despite all scenarios having a negative impact on funding, the impact was immaterial, or within current expected volatility levels. We would advise caution here, recognising the limitations of scenario modelling mentioned above, and we would advise schemes to not to place too much weight on quantitative scenario modelling until developments are made. There is also value in considering shorter-term qualitative scenarios to better appreciate the real-world implications of climate change for the scheme.

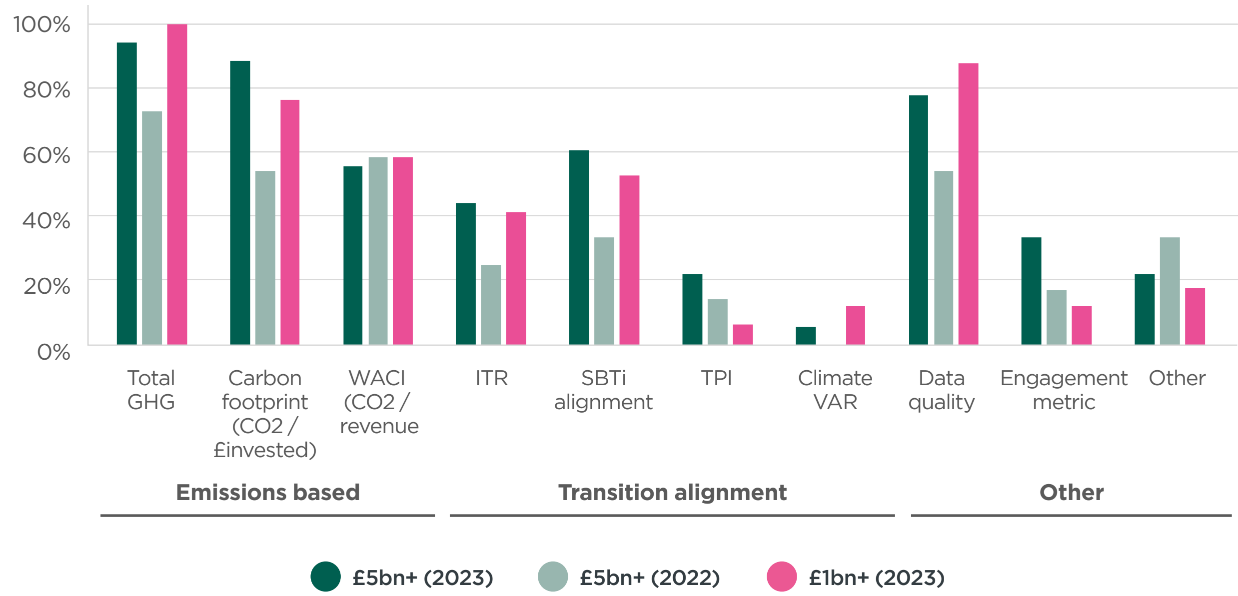
It was comforting to see some reports commenting that although funding is expected to improve due to mortality outcomes in the worst scenarios, this is clearly not in members' long-term interests.

2. Metrics and targets

Attention needed to increase coverage on transition alignment metrics

In 2023, schemes were subject to the new requirement to include a transition alignment metric. We saw all schemes include a transition alignment metric. The various options for this metric and their popularity are illustrated below.

Metrics disclosed by schemes



Note:

- *ITR = Implied Temperature Rise*
- *SBTi = Companies with approved targets under the Science Based Targets initiative*
- *TPI = Transition Pathway Initiative, industry body which assesses transition credentials of companies and assigns a score*
- *'Other' includes % exposure to sources of physical risk, % of funds with ESG tilting, % exposure to low carbon solutions*

Source: XPS review of publicly available TCFD reports

We saw schemes reporting increased coverage of carbon emissions within the listed portions of their portfolios. A greater number of funds were able to report and, for those funds, data was available for a greater % of holdings. However, there were still mixed results for other non-listed asset classes as was the case last year.

We observed more of the £5bn+ schemes able to report emissions for their illiquid portfolios, as these schemes have the scope and resource to engage with specialist data providers to produce the data, whereas most £1bn+ schemes simply excluded these assets from some or all of the metrics disclosed.

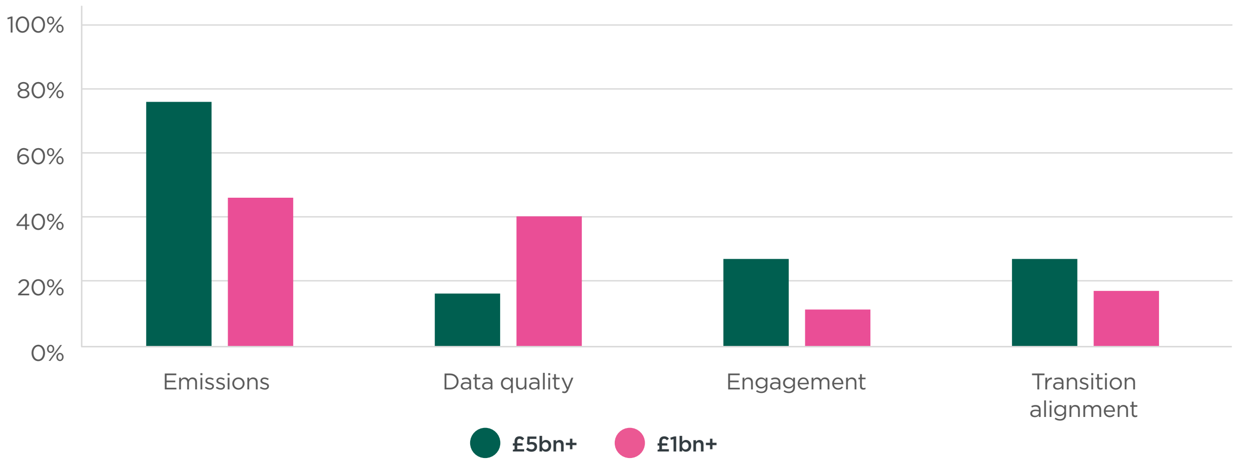
Transition alignment assessment is critical for schemes to understand their forward-looking exposure to risks, and coverage was generally poor here. It was common for schemes to report on transition alignment for fewer funds than they could on carbon emissions. Any robust Net Zero strategy requires good insight into the alignment to a given future temperature state, so this is an area where more focus is needed. The number of companies evaluated by Science Based Targets Initiative continues to grow, and methodologies on Implied Temperature rise are evolving, so we hope this flows through into reporting in future years.

As an approximate indication of the current state of alignment, we reviewed the Implied Temperature Rise (ITR) reported by Schemes and calculated a weighted average of **2.8°C** where disclosed (covering 14 schemes and £54bn of assets under management) with individual scheme level ITRs ranging between **2.0°C** and **3.3°C**. This suggests pension schemes are currently holding assets which are misaligned to the current pace of transition and risk being stranded investments.

Clear distinction between targets set by £5bn+ and £1bn+ schemes

The chart below summarises the nature of targets being set by £5bn+ and £1bn+ schemes. It was common for £1bn+ to set targets around data quality, which most schemes indicated was critical before being able to set more ambitious targets around Net Zero. Some schemes did set carbon reduction targets without necessarily setting a formal Net Zero strategy. £5bn+ schemes also tended to set multiple targets.

Targets for metrics set by schemes



Source: XPS review of publicly available TCFD reports

Engagement is critical for driving change so we encourage all schemes to have engagement targets which will prompt action by managers. Our research of asset managers this year indicated that of the ESG topics, governance was by far the most popular topic of engagement for managers. Therefore, pressure is needed from consultants and schemes to encourage more engagement with companies on the environment and climate change.

Lots of schemes are missing targets

A significant minority (**44%**) of £5bn+ schemes producing their second report indicated that they had missed or were not on track to meet their targets set last year. This is not cause for immediate concern as it has only been one year, and there is expected to be volatility on many metrics. For example, UK government emissions data is lagged by two years so reported emissions on gilts have this year increased due to the reversion to normal levels of activity post lock-down. What's important is that schemes recognise the source of change each year and engage with the fund managers to understand what is being done to address any issues.

3. TPR feedback and how schemes have this taken onboard

Following the first round of reporting the Pensions Regulator produced a review of the climate disclosures by pension schemes and indicated several areas where they had observed required information being omitted. In the table below we have set these out with our assessment on how we think schemes have responded to this.

Area	Observed alignment with TPR feedback
Governance	
The roles of those undertaking scheme governance activities other than trustees	**100%** of schemes reviewed provided a description of the role of the various stakeholders involved.
How trustees assess the credentials and competence of their employees or advisers	**63%** of schemes were clear on the assessment which had taken place of those responsible for assessing and managing climate risk.
Strategy and scenario analysis	
Assessing the relevant risks and opportunities for each time horizon	**63%** clearly described the climate risks relevant for each time period identified.
Impact of climate-related risks on the scheme's investment strategy and funding strategy	**57%** provided comment on the impact on broader funding strategy. This includes those that said that no changes to strategy were required.
Considering the impact on the sponsor covenant	**80%** included a comment on the sponsor covenant. For the most part this was qualitative, but some schemes included detailed analysis. Last year we found only 58% made any reference to the covenant.
Risk management	
The processes they have established for identifying, assessing and managing climate-related risks	In our view **100%** indicated their process. This was through a combination of ways such as using the reporting provided to them by consultants / managers, undertaking the scenario analysis, or going through the process of producing the TCFD report, all of which were examples of steps taken to identify the risks.
Metrics and targets	
Explanation as to why, when unable to obtain data	**69%** of schemes made it clear why data wasn't available and what was being done to improve.

In summary we feel **the majority of schemes do address most of the areas highlighted by tPR**, but in our view **there remain some who do not**. TPR have evidenced that they are not afraid to financially penalise schemes not meeting the requirements (one scheme was fined £5,000 for not posting their report visibly enough online).

Conclusion

Some criticism of TCFD is that it hasn't led to meaningful change. However, in our view, it has been instrumental in bringing climate change to the attention of pension scheme trustees. We're grateful for the time and effort spent by trustees and asset managers in working together to produce the reports we have worked on.

We're clear that reporting is the first step to successfully managing these risks and is not in our view detracting from more action being taken. Many schemes have made meaningful changes to portfolios in the interest of the financial security of their members, which will benefit the environment – for example, by switching to funds focussed on aligning to the climate transition and directly financing climate solutions. For £1bn+ schemes, many have taken a less comprehensive approach towards TCFD reporting in their first year, so we hope to see many of those make progress to better embed the risks and opportunities associated with climate change in their portfolios. We are still waiting for clarification on how schemes <£1bn will need to comply with TCFD.

As global policy and regulation continues to evolve slowly, delivery of the legally binding Paris Agreement will result in an increasingly disruptive transition, amplifying the risks for those schemes not positioning themselves appropriately. Any holdings with an Implied Temperature Rise in excess of the current projections, or which are not deemed to be aligning to the transition, should give cause for concern.

Developing a robust climate strategy

For schemes who are looking to develop a robust climate strategy, we think this strategy must be built around the following core aspects:

Transition alignment

The overall objective of a climate strategy should be to contribute to and align to delivery of the Paris Agreement.

Carbon reduction

Global decarbonisation is important for slowing and reversing global warming, therefore schemes should play their part by setting a clear pathway for reduction.

Engagement

To deliver on the other two aspects, engagement with managers and with underlying companies is key to driving progress.

Data coverage has increased significantly, and whilst not perfect does provide ample information for trustees to make decisions.

Actions for trustees

- Undertake ongoing training to understand latest developments and best practice.
- Speak to your consultant about defining or enhancing your climate strategy around the aspects on the prior page.
- Assess transition alignment across your portfolio – engage with your managers on what they are doing to be able to assess this for their investments and which of your holdings contribute to climate solutions. Most schemes now have a pretty good sense of their carbon emissions, so turn focus to forward-looking transition alignment to identify obvious sources of risk.
- Consider the growing range of funds available which have climate objectives embedded. These do not detract from broader financial objectives and meaningful real-world outcomes can be achieved by switching.

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.

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