TCFD: An introduction for pension trustees

The Taskforce on Climate-Related Financial Disclosures (TCFD) recommendations for climate disclosures are driving improvements in climate-related practices by companies and financial institutions around the world. An industry working group is developing guidance for UK pension scheme trustees and the Pensions Regulator (TPR) will consult on this topic in 2020.

Suggested actions for trustees

01

Familiarise yourselves with climate change and the TCFD recommendations ahead of TPR's consultation. The recommendations may seem onerous but include some useful pointers for managing climate-related risks and opportunities.

02

Consider how you could enhance your climate approach in a proportionate manner. This could include: identifying how climate-related factors might affect your scheme; questioning your investment managers on how these factors are currently being managed; and incorporating climate aware funds in your investment strategy.

03

Look out for the working group's guidance in the next few months.

What is the Taskforce on Climate-Related Financial Disclosures (TCFD)?

The TCFD was established by the international Financial Stability Board in 2015 in response to a request by the G20 Finance Ministers and Central Bank Governors. Its remit was to develop voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders and insurance underwriters in understanding the serious risks that climate change poses to the global economy and organisations within it.

The TCFD issued its final disclosure recommendations for all types of organisations – including pension schemes, their investment managers and the companies they invest in – in June 2017 and is now encouraging their adoption. Whilst the recommendations are voluntary for now, over 850 organisations and companies have committed to following them[1]. They have been endorsed by the UK government and the Bank of England.

Why is this important to you?

In July 2019, the UK government launched its Green Finance Strategy which included the following announcements:

- The government expects listed companies and 'large' asset owners (eg pension schemes) to provide disclosures in line with the TCFD recommendations by 2022.
- An industry working group is developing TCFD-related guidance for pension schemes. TPR will consult on this in 2020 with a view to incorporate it into a Code of Practice applicable to both DB and DC pension schemes.
- The government is establishing a taskforce with UK regulators to ensure a co-ordinated approach on climate-related financial issues. The taskforce will examine the most effective way to approach disclosure, including exploring the appropriateness of mandatory reporting.

This co-ordinated approach by both government and regulators is rather unusual and demonstrates the seriousness of their intentions. It reinforces the need for trustees to consider their approach to climate-related issues as part of their fiduciary role.

Trustees are already expected to have a policy on taking account of climate change in their investment decisions: it is named as a financially material consideration in the regulations that set out statements required in a Statement of Investment Principles (SIP). Climate change is also explicitly referenced in TPR's investment guidance for DB trustees and DC trustees. TPR says that trustees should consider the TCFD recommendations.

[1] As at September 2019

LCP view

Climate change and actions to prevent climate change – such as government policies and technological innovation – will have material consequences for pension schemes, over both the shorter and longer term. The TCFD's recommendations are not just about **disclosing** the actions that schemes are taking to address these consequences: they provide a helpful framework for schemes to assess the consequences and decide on a course of **action**.

We suggest that trustees use the TCFD's recommendations as a basis for developing their approach to climate-related risks and opportunities ahead of the promised industry guidance. Some schemes may wish to get on the front foot by starting to disclose their approach in line with the TCFD's recommendations.

The TCFD recommendations: overview

The recommended disclosures for all organisations, including pension schemes, encompass four key areas.

Source: TCFD final report June 2017

Governance – the organisation's governance around climate-related risks and opportunities;

Strategy – the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning;

Risk management – the processes used by the organisation to identify, assess, and manage climate-related risks; and

Metrics and targets – the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

The TCFD intends these disclosures to be incorporated in the organisations' standard financial reporting (eg in their annual report and accounts), although many organisations are choosing to publish separate climate reports instead at this stage.

The TCFD recommendations for asset owners: detail

Governance

Disclose the organisation's governance around climate-related risks and opportunities

TCFD recommendation	LCP interpretation of TCFD guidance[2]
a) Describe the board's oversight of climate-related risks and opportunities.	In their disclosures, schemes should consider including a discussion of: • Processes and frequency by which the trustees and/or sub-committees are informed about climate-related issues. • Whether the trustees and/or sub-committees consider climate-related issues when setting investment strategy and monitoring implementation and performance, and for DB schemes, when reviewing funding strategy, risk management policies and journey plans and assessing and monitoring sponsor covenant. • How the board monitors and oversees progress against goals and targets for addressing climate-related issues.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	Schemes should consider disclosing: • Whether the trustees have assigned climate-related responsibilities to the pensions manager, other in-house staff, advisers and investment managers; and if so, whether these people report to the trustees or a sub-committee and whether those responsibilities include assessing and/or managing climate-related issues. • A description of the associated governance structures. • Processes by which these people are informed about climate-related issues, and • How these people monitor climate-related issues.

[2] The TCFD's guidance is not written with pension scheme trustees in mind, so we have interpreted it for trustees while following the original text reasonably closely.

Strategy

Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.

TCFD recommendation	LCP interpretation of TCFD guidance
a) Describe the climate-related risks and opportunities the organisation has identified over the short, medium and long term.	Schemes should provide: • A description of what they consider to be the relevant short, medium and long term horizons mindful of the fact that climate-related issues often manifest themselves over the medium and longer term. For DB schemes, this means taking into consideration the duration of any recovery plan and journey plan and the length of time needed for the funding of future benefits by the investments of the scheme. For DC schemes, this means taking into consideration the age profile of the membership. • Specific climate-related issues for each time horizon (short, medium and long term) that could have a material financial impact on the scheme and distinguish whether the climate-related risks are transition or physical risks, and • A description of the process(es) used to determine which risks and opportunities could have a material financial impact on the scheme. For DC schemes, this might include consideration of the members' risk tolerance, using a similar approach to that taken when developing the default strategy. Schemes should consider providing a description of their risks and opportunities by investment mandate or asset class (which may be further broken down by sector and/or geography).
b) Describe the impact of climate-related risks and opportunities on the organisation's business, strategy and financial planning.	Schemes should describe how climate-related risks and opportunities are factored into relevant investment strategies. This could be described from the perspective of the overall investment strategy or individual asset classes. DB schemes should also describe how identified climate-related issues are factored into their funding strategy and journey plans. If climate-related scenarios were used to inform the scheme's strategic planning, such scenarios should be described.
c) Describe the resilience of the organisation's strategy, taking into consideration different climate-related scenarios, including a 2ºC or lower scenario.	Schemes should describe how resilient their strategies are to climate-related risks and opportunities, taking into consideration a transition to a lower-carbon economy consistent with a 2ºC or lower scenario and, where relevant to the scheme, scenarios consistent with increased physical climate-related risks. Schemes should consider discussing in their disclosures: • Where they believe their strategies may be affected by climate-related risks and opportunities; • How their strategies might change to address such potential risks and opportunities; • How climate-related scenarios are used, such as to inform investments in specific assets; and • The climate-related scenarios and associated time horizon(s) considered.

Risk Management

Disclose how does the organisation identifies, assesses and manages climate-related risks.

TCFD recommendation	LCP interpretation of TCFD guidance
a) Describe the organisation's processes for identifying and assessing climate-related risks.	Schemes should describe their risk management processes for identifying and assessing climate-related risks. An important aspect of this description is how schemes determine the relative significance of climate-related risks in relation to other risks. Schemes should describe whether they consider existing and emerging regulatory requirements related to climate change (eg limits on emissions) as well as other relevant factors considered. Schemes should describe, where appropriate, engagement activity undertaken by them or their investment managers to encourage better disclosure and practices related to climate-related risks to improve data availability and their ability to assess climate-related risks. Schemes should also consider disclosing the following: • Processes for assessing the potential size and scope of identified climate-related risks; and • Definition of risk terminology used or references to existing risk classification frameworks.

Risk Management *(continued)*

b) Describe the organisation's processes for managing climate-related risks.	Schemes should describe their processes for managing climate-related risks, including how they make decisions to mitigate, transfer, accept, or control those risks. In addition, schemes should describe their processes for prioritizing climate- related risks, including how materiality determinations are made. Trustees should describe how they consider the positioning across their investments with respect to the transition to a lower carbon economy. This could include explaining how they actively manage their portfolio's positioning in relation to this transition.
c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organisation's overall risk management.	Trustees should describe how their processes for identifying, assessing, and managing climate-related risks are integrated into their overall risk management.

Metrics and Targets

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

TCFD recommendation	**LCP interpretation of TCFD guidance**
a) Disclose the metrics used by the organisations to assess climate-related risks and opportunities in line with its strategy and risk management process.	Schemes should describe the metrics used to assess climate-related risks and opportunities in each fund or investment strategy. Where relevant, schemes should also describe how these metrics have changed over time. Trustees should provide any metrics considered in investment decisions and monitoring. Where climate-related issues are material, trustees should consider describing whether, and how, related performance metrics are incorporated into investment management agreements. Metrics should be provided for historical periods to allow for trend analysis. In addition, where not apparent, schemes should provide a description of the methodologies used to calculate or estimate climate-related metrics.
b) Disclose Scope 1, Scope 2 and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks. [3]	Schemes should provide the weighted average carbon intensity, where data is available or can be reasonably estimated, for each fund or investment strategy. In addition, schemes should provide other metrics they believe are useful for decision making along with a description of the methodology used. GHG emissions and associated metrics should be provided for historical periods to allow for trend analysis. In addition, where not apparent, schemes should provide a description of the methodologies used to calculate or estimate the metrics.
c) Describe the targets used by the organisation to manage climate-related risks and opportunities and performance against targets.	Schemes should describe their key climate-related targets such as those related to GHG emissions, water usage, energy usage etc., in line with anticipated regulatory requirements or market constraints or other goals. In describing their targets, schemes should consider including the following: • Whether the target is absolute or intensity based, • Time frames over which the target applies, • Base year from which progress is measured, and • Key performance indicators used to assess progress against targets. Where not apparent, schemes should provide a description of the methodologies used to calculate targets and measures.

[3] Scope 1 GHG are emitted directly by investee companies in their operations. Scope 2 GHG are emitted in the generation of electricity used by investee companies. Scope 3 GHG are indirect emissions arising from companies' supply chains and the use and disposal of their products.

Conclusion

The approach of pension scheme trustees to climate change is facing increasing scrutiny due to strong interest from regulators, politicians and members. The forthcoming pensions industry guidance on the TCFD recommendations is just one aspect of this. Expectations on the level of disclosure and risk oversight performed by trustees are likely to rise over the next few years, and may lead to mandatory requirements. We therefore recommend that trustees allocate time over the next year to review and enhance their approach to managing climate-related risks and opportunities.

Some practical steps you can take now

- Clarify your governance structure: who is responsibile for identifying, managing and monitoring climate-related issues shared between the trustees, sub-committees, in-house staff, advisers and investment managers?
- Learn more about climate change and how it might affect your pension scheme: see our primer for trustees.
- Discuss how climate-related risks and opportunities are relevant to your scheme over short, medium and long term horizons.
- Add climate-related risks to the risk register.
- Question your investment managers and consultants on how climate-related factors are being managed in your investment portfolio and how they could be reduced.
- Consider incorporating climate aware funds in the investment strategy, eg by replacing passive equity funds with climate-tilted versions.
- For DB, consider climate-related risks and opportunities in future reviews of the sponsor covenant.

Want to find out more?

If you would like further information, please contact your usual LCP adviser or one of the people below.

Paul Gibney - Partner
+44 (0)20 7432 6653
paul.gibney@lcp.uk.com

Claire Jones - Principal
+44 (0)1962 873373
claire.jones@lcp.uk.com

Nigel Dunn - Senior Consultant
+44 (0)20 7432 7795
nigel.dunn@lcp.uk.com

Ada Chan - Associate Consultant
+44 (0)20 7432 3085
ada.chan@lcp.uk.com

At LCP, our experts provide clear, concise advice focused on your needs. We use innovative technology to give you real time insight & control. Our experts work in pensions, investment, insurance, energy and employee benefits.