



Climate change and pensions: what trustees should know

2 March 2022



Chair

Introduction

Claire Southern, Hogan Lovells



The job of a pension scheme trustee is never done . . .

- Significant new area of governance and reporting obligations
- Brings together many different strands – legal, investment, covenant, actuarial . . .
- If done properly it is more than just an annual report
- Powers that be have decided to make it as complicated as possible – with statutory requirements, DWP and tPR guidance and industry guidance
- Never fear we have put together a crack team of experts to help trustees!

The TCFD crack team!



Legal
Edward Brown
Hogan Lovells



Investment
James Leeming
XPS Pensions
Group



Covenant
Jane Evans
EY

Part 1

Legal overview

Edward Brown, Hogan Lovells



TCFD: Introduction

- TCFD?
- TCFD represents a significant new area of governance and reporting obligations in respect of climate change
- Substantial new legislation
- Extensive statutory (DWP) and non-statutory (Pensions Climate Risk Industry Group, tPR) guidance

New requirements: overview

- Governance:
 - Trustees must put in place “*effective system of governance with respect to the effects of climate change*”
 - Regulations impose requirements concerning TKU, risk management, scenario-testing and measuring climate change metrics
 - “CRRO” climate-related risks and opportunities
- TCFD reporting:
 - At the end of each scheme year, publish a TCFD report broadly explaining how the Trustees have complied with their climate change governance obligations
- What discretion do Trustees have?
 - Status of DWP guidance
 - “*Must do*” vs “*Should do*” vs “*May do*”
 - Undertake certain tasks “as far as they are able”

To whom do the requirements apply?

- MasterTrusts and £5bil + schemes:
 - Governance requirements apply from 1 October 2021
 - TCFD report 7 months after first scheme year end-date after 1 October 2021
- £1bil + schemes:
 - Governance requirements apply from 1 October 2022
 - TCFD report 7 months after first scheme year-end date after 1 October 2022
- Does not yet apply to smaller schemes but:
 - Clear direction of travel
 - Climate change risks & opportunities still relevant for smaller schemes – obliged to consider under SIP anyway
 - TPR guidance – smaller schemes “*may wish to follow this guidance to improve the governance and resilience of their schemes in relation to climate change*”
- Penalties:
 - Compliance Notice
 - Fine (£5K individuals; £50K corporates) for non-compliance generally (discretionary)
 - Mandatory fine (£2.5K minimum) for failing to publish the TCFD report on website

Key concept – “as far as they are able”

- Will there be sufficient data available for Trustees to be able to comply with these new requirements?
- “*As far as they are able*”:
 - Take steps that are reasonable and proportionate in the circumstances
 - Take into account the costs incurred by the scheme and the time required to be spent by the Trustees

TCFD Governance requirements 1

Requirements	Actions for Trustees
Trustee Knowledge and Understanding	
<ul style="list-style-type: none"> Have knowledge and understanding of principles relating to the identification, assessment and management of relevant CRROs 	<ul style="list-style-type: none"> Consider what training the Trustees need Does the employer want to be involved too?
Governance	
<ul style="list-style-type: none"> Establish and maintain oversight of CRROs relevant to the Scheme Establish processes to satisfy the Trustees that those assisting with or advising on governance activities are identifying and managing climate-related risks and opportunities relevant to their role 	<ul style="list-style-type: none"> Decide on appropriate governance structure Who will be advising – investment, covenant, in-house team? Check advisers’ expertise: (i) take it as a given; (ii) ask for confirmation; (iii) brief questionnaire?

TCFD Governance requirements 2

Requirements	Actions for Trustees
Risk Management	
<ul style="list-style-type: none"> Establish and maintain processes for the identification, assessment and management of climate-related risks relevant to the Scheme Incorporate climate related risks into the trustees' overall risk management 	<ul style="list-style-type: none"> Check climate change is included in the risk register DWP Guidance asks Trustees to reflect whether the time horizon over which risks are assessed is sufficiently long-term to take account of climate-related risk
Strategy	
<ul style="list-style-type: none"> Identify and assess the impact of CRROs on the Scheme's funding and investment strategy Need to consider effect over short, medium & long-term 	<ul style="list-style-type: none"> Inherently interlinked – but the analysis/answers may be different (depending on funding level & employer covenant). What is short, medium & long-term for your Scheme? Climate opportunities?

TCFD Governance requirements 3

Requirements	Actions for Trustees
Scenario analysis	
<ul style="list-style-type: none"> • *As far as they are able* undertake scenario analysis and at least every three years onwards to assess what impact increasing global temperatures would have on the Scheme 	<ul style="list-style-type: none"> • Understand from investment adviser what scenario analysis tools they have available to assist the Trustees • Decide what scenarios should be analysed and whether the data will be available to carry it out • When should scenarios be tested
Metrics and targets	
<ul style="list-style-type: none"> • *As far as they are able* calculate: <ul style="list-style-type: none"> • one absolute emissions metric; • one emissions intensity metric; and • one additional climate change metric; and • DWP consulting on portfolio alignment metric (to align to Paris agreement) • Set – for at least 1 metrics – a target for improvement • Measure annually 	<ul style="list-style-type: none"> • Discuss with the investment adviser what metrics will be calculated and reported on and what data is available • Consider what would be a realistic and achievable target to set for the Scheme to manage-climate related risks it identifies

TCFD Reporting requirements

- Prepare and issue a TCFD Report:
 - Within 7 months (same as accounts) of scheme year-end date;
 - Which first arose after the requirements applied to the scheme
- For schemes with 31 December year-end, TCFD requirements may only have been around 3 months
- Publication – must be published on publicly-available website

TCFD Report - content

How the Trustees maintain oversight of CRROs	Role of people assessing CRROs for the Scheme and how the Trustees have satisfied themselves of their expertise
What CRROs have the Trustees identified?	What is short, medium & long-term
Impact of CRROs on funding & investment strategy	Results of most recent scenario-testing
Impacts of the scenario testing on assets & liabilities, or explanation as to why this information is not available	Resilience of the funding and investment strategy resulting from the scenario testing
If Trustees have decided not to undertake scenario testing between the 3 years, explain why not	Risk management processes for CRROs
How CRRO risk management processes are integrated into overall risk management for the Scheme	Metrics the Trustees have calculated (or explain why they can't calculate them)
Scheme's emission targets and performance against those targets	

Part 2

Investment overview

James Leeming, XPS Pensions Group



TCFD & Investment

What do schemes need to do under the TCFD requirements from an investment perspective?

1

Describe and identify **key risks and opportunities**

2

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

3

Select metrics

4

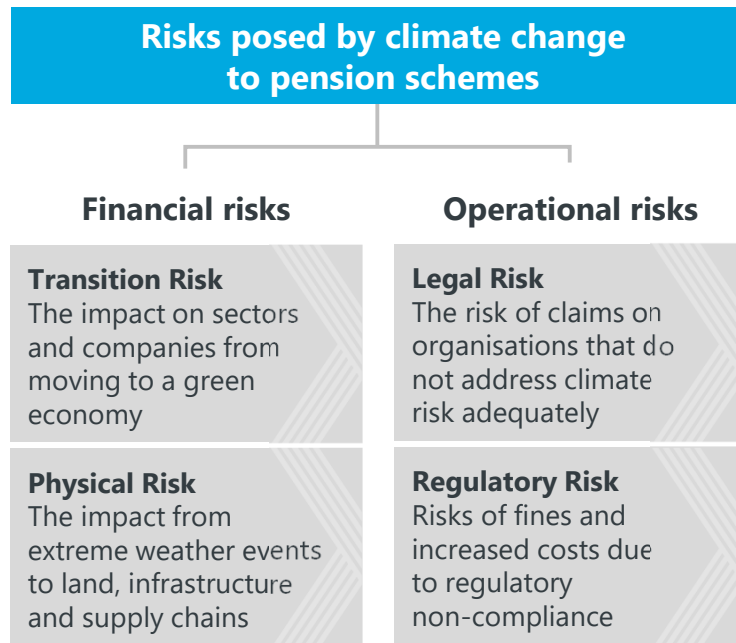
Set targets against metrics

5

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

Key risks and opportunities

Trustees need to think about and describe what risks their schemes face.



Integration of climate risk

Climate risks are systemic / linked and should be considered as part of integrated risk management (IRM)

- Climate risk impacts the global economy and affects **assets, liabilities and sponsor covenants**.
- Specific risks can affect companies that fail to prepare for transition – this can include both investee companies and sponsor covenant
- Effective governance** is required to understand the key risks and their potential impact and to manage these
- IRM can also help **identify where the scheme can benefit from opportunities**
- Consider **regular ongoing monitoring** as you do with other risk exposures – liaise with consultant and managers

The diagram is a large triangle divided into four smaller triangles meeting at a central point. The top triangle is yellow and labeled 'Covenant'. The bottom-left triangle is green and labeled 'Funding'. The bottom-right triangle is blue and labeled 'Investment'. The central triangle is dark blue and labeled 'Members'.

The documents shown are titled 'Climate exposure'. One document features a bar chart comparing the carbon intensity of various funds against a benchmark. The chart shows bars for 'Climate Risk', 'Transition', 'Fossil Fuels', and 'Other Sectors'. The y-axis is labeled 'CO2e/£1M' and ranges from 0 to 300. The x-axis lists several funds.

The second document contains a table with the following data:

Fund Name	Carbon Footprint (CO2e/£1M invested)		Carbon Weighted Intensity (CO2e/£1M AUM)		Proportion of portfolio 'exposed'
	Fund	Benchmark	Fund	Benchmark	
FUND A	114.8	109	102.2	109	70%
FUND B	92.2	89.9	103.0	105.0	50%
FUND C	94.9	94.4	102.3	102.3	90%
FUND D	94.9	94.4	102.3	102.3	95%
FUND E	Not provided	109	102.0	109	100%

Footnote 1: Key terms and definitions are provided in the Annex to the Appendix.
 Footnote 2: Data refers to the latest available data provided by the fund manager / asset provider and may not reflect the entire holding reporting on the availability of data.
 Footnote 3: Coverage refers to the proportion of the fund's assets covered and may not reflect the entire holding reporting on the availability of data.
 Footnote 4: Values shown are the 2021 Scope 1 and 2 values only.

Scenario analysis

Trustees should spend time sufficient time thinking about how schemes may be impacted in future scenarios

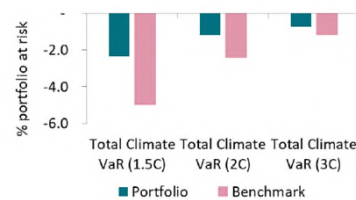
Regulation and guidance?

- ▶ At least 2 scenarios, including one aligned to 1.5C
- ▶ Guidance suggests two approaches
 - ▶ **Qualitative** – describe what the impacts could be
 - ▶ **Quantitative** – modelling, perhaps sensitivity analysis of impacts on portfolios and funding
- ▶ Both approaches require significant forethought – engage with your advisers / managers

Current availability of models?

- ▶ Models and tools in development – most managers can provide ‘something’ for their funds now
- ▶ Challenges? Aggregation of modelling across your portfolio (data availability, different assumptions / methods)

Carbon Value at Risk



Timeframe of analysis

- ▶ Consider scenarios and modelling over short, medium and long term relevant to your scheme
- ▶ Recognise that the timeframes themselves may change over time
- ▶ Most modelling will reference 2050 risks (aligned to Paris Agreement transition)

Metrics

Under the TCFD reporting requirements, schemes must **select at least three metrics** to calculate in relation to the scheme's assets:

- **two emissions-based (outcome) metrics** – one absolute measure and one intensity measure; and
- **one other (outcome or process) metric.**

Current consultation may lead to **introduction of an additional 'Transition Alignment' metric.**

Freedom to report on any others which add valuable insight.

Metric chosen can vary between asset classes in your portfolio.

Guidance from TPR is to select the following:

Metric	Definition	Pros and Cons
Outcome metrics		
Total emissions (CO₂e)	<ul style="list-style-type: none"> ➤ Measures the absolute 'owned emissions'. 	<ul style="list-style-type: none"> ✓ Real world emissions and ultimate target for net zero ✓ Simple to calculate and understand ✗ Limited usefulness for benchmarking and comparison
Carbon emissions normalised per £m invested (a.k.a 'Carbon footprint') (CO₂e / £m invested)	<ul style="list-style-type: none"> ➤ 'Owned' emissions standardised per £million invested. ➤ This is an intensity measure. 	<ul style="list-style-type: none"> ✓ Suitable for comparison between portfolios ✗ Less relevant for given portfolio manager ✗ Does not measure risk and opportunity.
Weighted Average Carbon Intensity (WACI) (CO₂e / £m sales)	<ul style="list-style-type: none"> ➤ 'Owned' emissions standardised using revenue generated ➤ WACI is an intensity measure 	<ul style="list-style-type: none"> ✓ Applicable across asset classes, including fixed income ✓ Indicates portfolio's relative exposure to potential climate change-related risks ✗ Vastly different across industries

Other useful metrics

Carbon emissions measures are inherently backward-looking and therefore other measures may be useful to provide a forward-looking assessment of climate change risk exposure. This is not an exhaustive list.

Metric	Definition	Pros and Cons
Outcome metrics		
Exposure to companies active in fossil fuel extraction	<ul style="list-style-type: none"> Companies within the portfolio with revenues linked to fossil fuel extraction activities. 	<ul style="list-style-type: none"> ✓ Simple to understand ✗ Further insight needed to fully understand prospects for change in practices by those companies.
Exposure to companies with high physical risks	<ul style="list-style-type: none"> Proportion of assets operating, investing, or financing activities exposed to physical risks based on key categories of commonly accepted risks. 	<ul style="list-style-type: none"> ✓ Simple to understand and calculate ✗ Variation of methodologies in development
Implied Temperature Rise (ITR)	<ul style="list-style-type: none"> Estimates global temperature rise (above pre-industrial levels) associated with current and estimated emissions of a company. Example “transition alignment” metric 	<ul style="list-style-type: none"> ✓ Proxy for climate related risks and opportunities of portfolio ✓ Indication of portfolio alignment to Paris Agreement targets ✗ Variation of methodologies in development ✗ Coverage limitations.
Climate VAR	<ul style="list-style-type: none"> Measure the size of the loss attributable to climate-related risks a portfolio may experience 	<ul style="list-style-type: none"> ✓ Attributes tangible £ amount for comparison ✗ Complex and methodologies in development
Process metrics		
Climate-related engagements	<ul style="list-style-type: none"> Companies in the portfolio where engagement or voting on climate-related risks and opportunities has been a substantive topic over the previous 12 months 	<ul style="list-style-type: none"> ✓ Simple to understand ✗ Hard to quantify risk impact / benefits of engagements.
Data quality	<ul style="list-style-type: none"> Represent the proportions of the portfolio for which the trustees have high quality data 	<ul style="list-style-type: none"> ✓ Simple to understand and useful for asset classes where methodology for other metrics is not developed. ✗ Subjective and methodology differences exist.

Targets

Trustees must 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.

Points to note

Flexibility around target-setting – it can be portfolio-wide or could relate to a particular sector or fund.

The target (or an interim target) set should be not more than 10 years into the future, in order to help trustees consider and manage risk.

Example targets:

Outcome Example 1:	Reduce the Portfolio Carbon Footprint (Scope 1+2) by 20% by 2025, 50% by 2030 and 100% by 2050, using 2020 as the base year.
Outcome Example 2:	Reduce the Implied Temperature Rise of the portfolio by XC, relative to position at 2020.
Process Example 3:	Reduce percentage of asset value exposed to transition risks by 30% by 2030, relative to 2020 baseline.
Process Example 4:	Target X% increase in the number of engagements with high carbon emitters on emission reduction targets aligned with the Paris Agreement.

Data coverage

Mind the gap!

- » Availability of data and coverage can **vary significantly** between managers and across asset classes.
- » **Listed equities and bonds have good availability:**
 - XPS survey shows that 95% equity and fixed interest managers could provide carbon reporting.
 - But understand the coverage and future variability of the data you receive
- » **Work to do for other asset classes:** private markets, high yield bonds, property, infrastructure – although methodologies are improving.
- » **Geographic dimension:** different regional adoption of climate related goals, targets and timeframes impact availability of data. e.g. emerging markets.
- » **Remember “as far as able”....don't let perfection get in the way of good!**

Do expect gaps...explain

Understand volatility in data

Mitigating risks and impact on strategy

Having identified the risks under current arrangements, what can you do next?

Integration of ESG and climate change	<ul style="list-style-type: none">▶ Critical for risk management to consider ESG and climate change factors when managers make investment decisions	Invest with those managers who do this best Get advice / monitoring from investment consultant
Engagement	<ul style="list-style-type: none">▶ Engagement with managers and underlying companies (including voting) to improve outcomes and reduce risk	
Exclusions	<ul style="list-style-type: none">▶ Exclude those companies which are most exposed to climate transition with no plans to improve▶ Should be at a minimum to exclude only the worst offenders	
Consider sustainable funds	<ul style="list-style-type: none">▶ Growing range of climate aware investment solutions available▶ Align investments to those companies best placed to thrive in low carbon economy – reduce risk and find opportunity▶ May have net zero target as part of fund objective	

Final thoughts

Undertake training

As required to cement understanding of key issues

Speak to investment consultant

Assign clear responsibilities and timeframe for carrying out analysis and compliance

Discuss and establish Trustee beliefs

Integration of climate change means different things to different people

Speak to existing managers

About availability of data and scenario analysis that they can provide

Set Policy around climate change

To inform engagement with managers and decisions within investment strategy

Speak to the sponsor

How does TCFD and climate change affect the covenant

Part 3

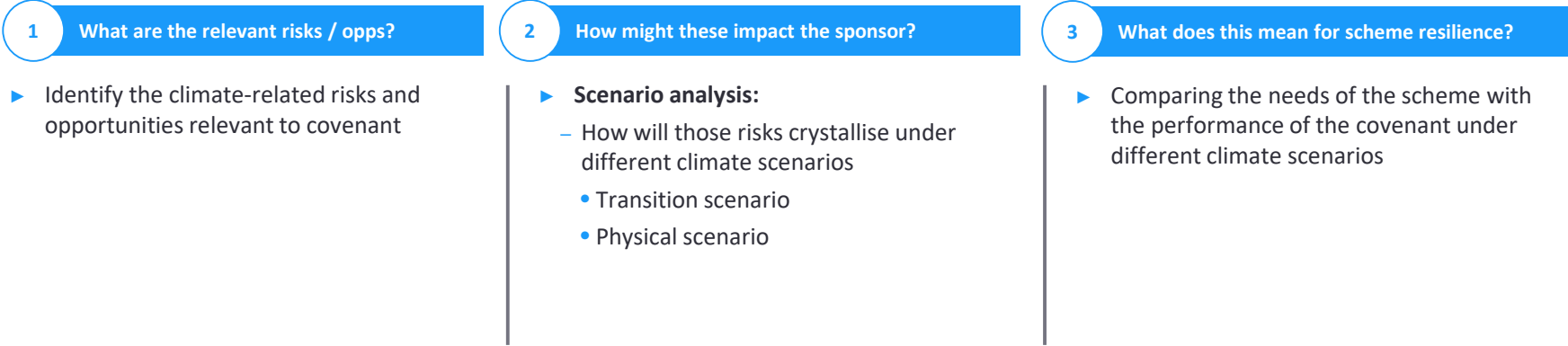
Covenant overview

Jane Evans, EY-Parthenon



Where does covenant come in?

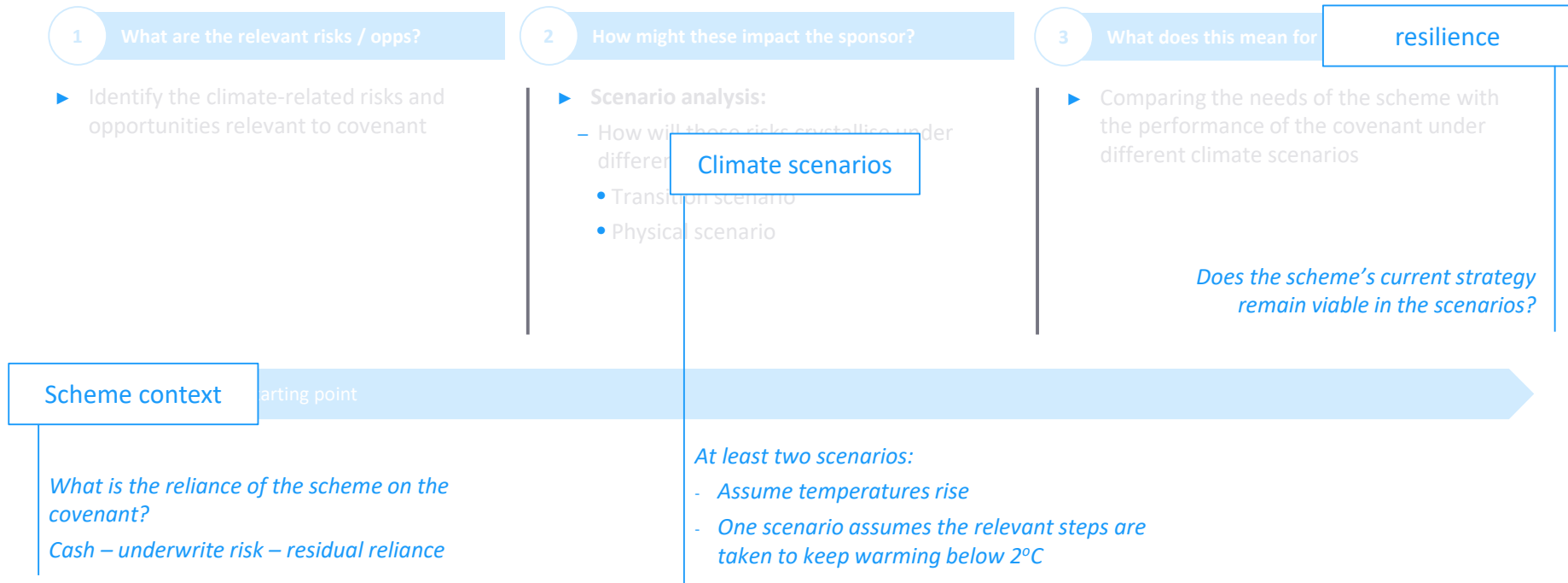
Can distil requirements down to building blocks:



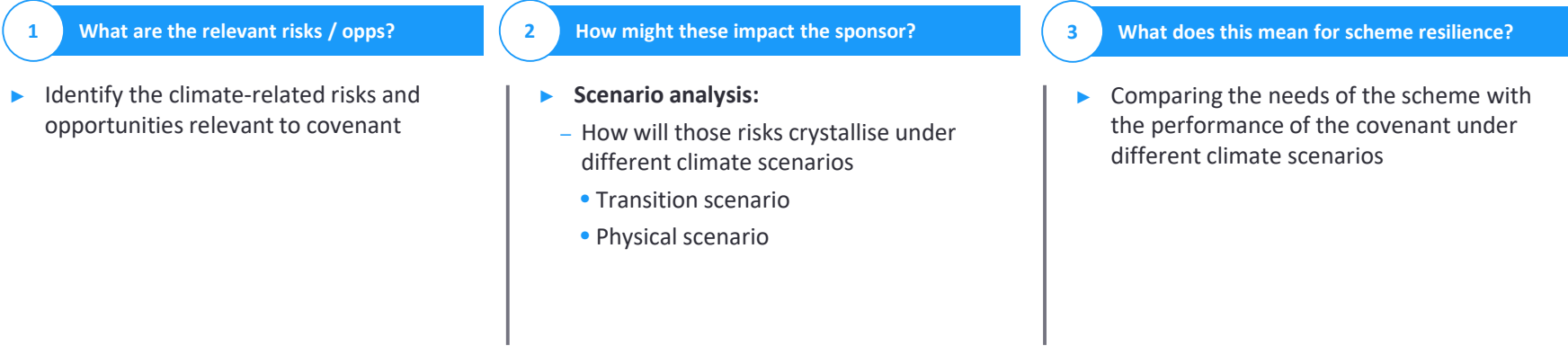
Scheme context is the starting point

Where does covenant come in?

Some key concepts:



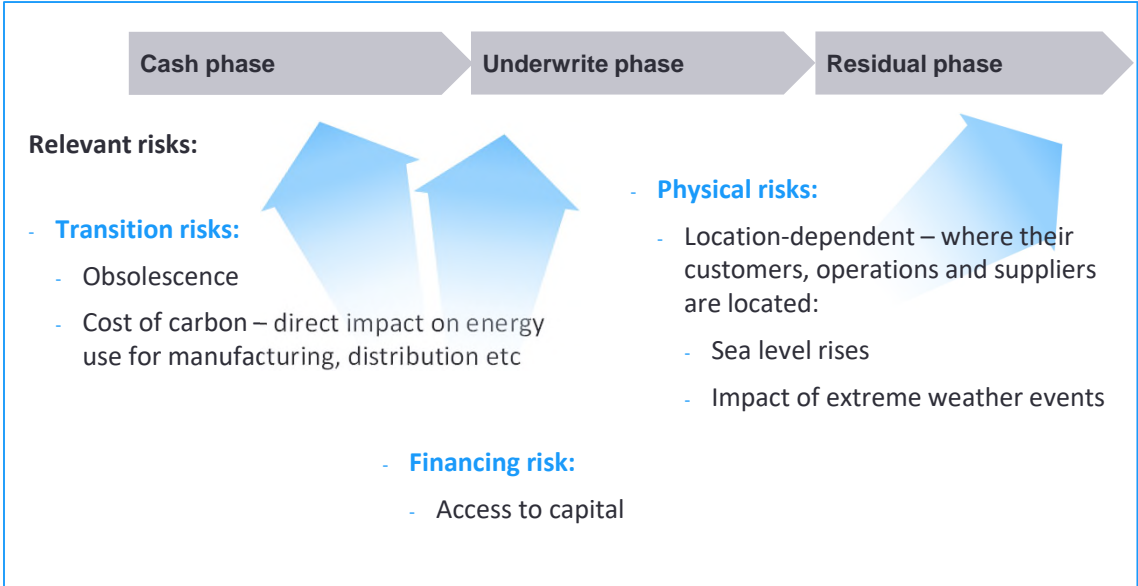
Where does covenant come in?



Scheme context is the starting point

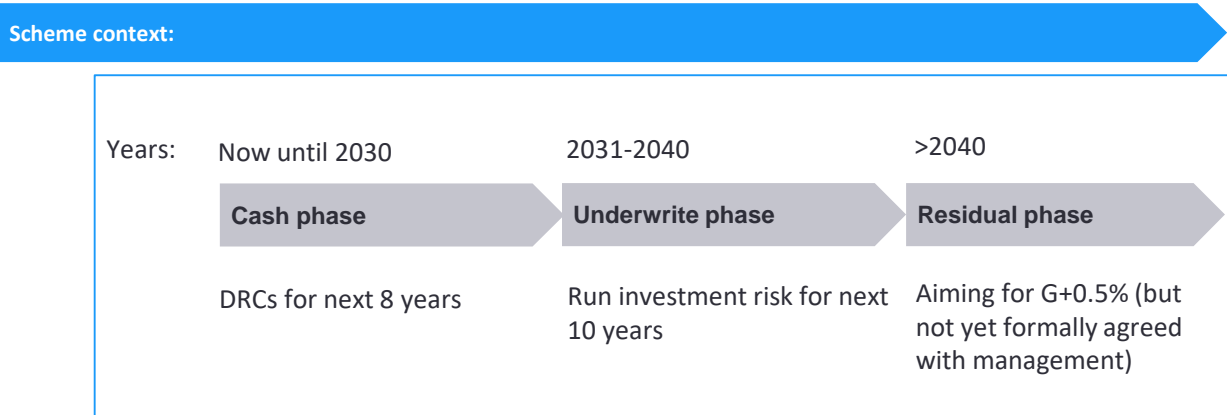
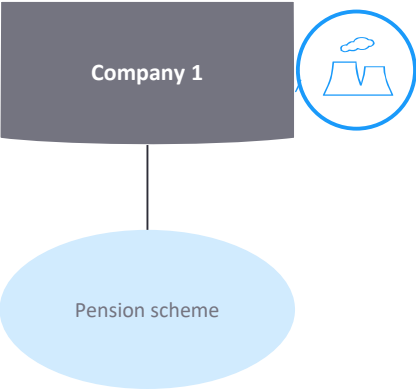
Context for scheme resilience

Scheme context:



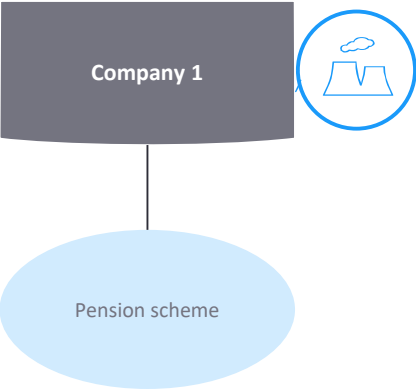
Case study 1

- ▶ Carbon-intensive employer with underfunded scheme

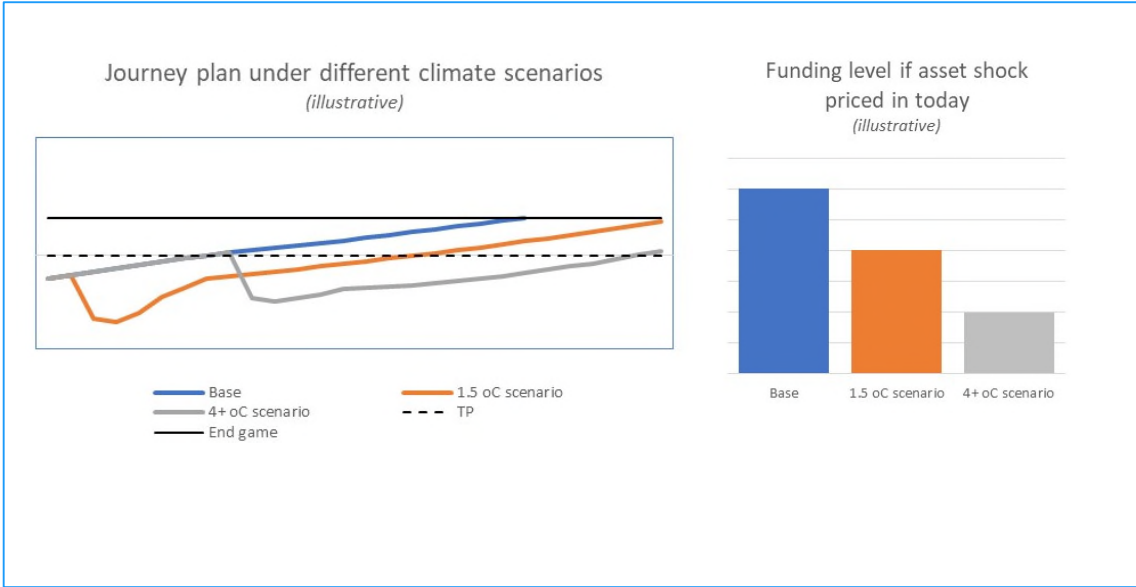


Case study 1

- ▶ Carbon-intensive employer with underfunded scheme



Overlay scenario results from scheme assets and liabilities:



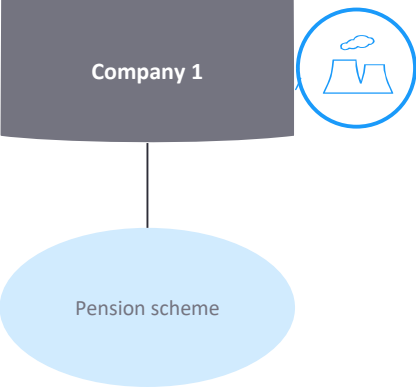
Case study 1

- ▶ Carbon-intensive employer with underfunded scheme



Case study 1

- ▶ Carbon-intensive employer with underfunded scheme



Sponsor scenarios:

Now until 2030	2031-2040	>2040
Cash phase	Underwrite phase	Residual phase

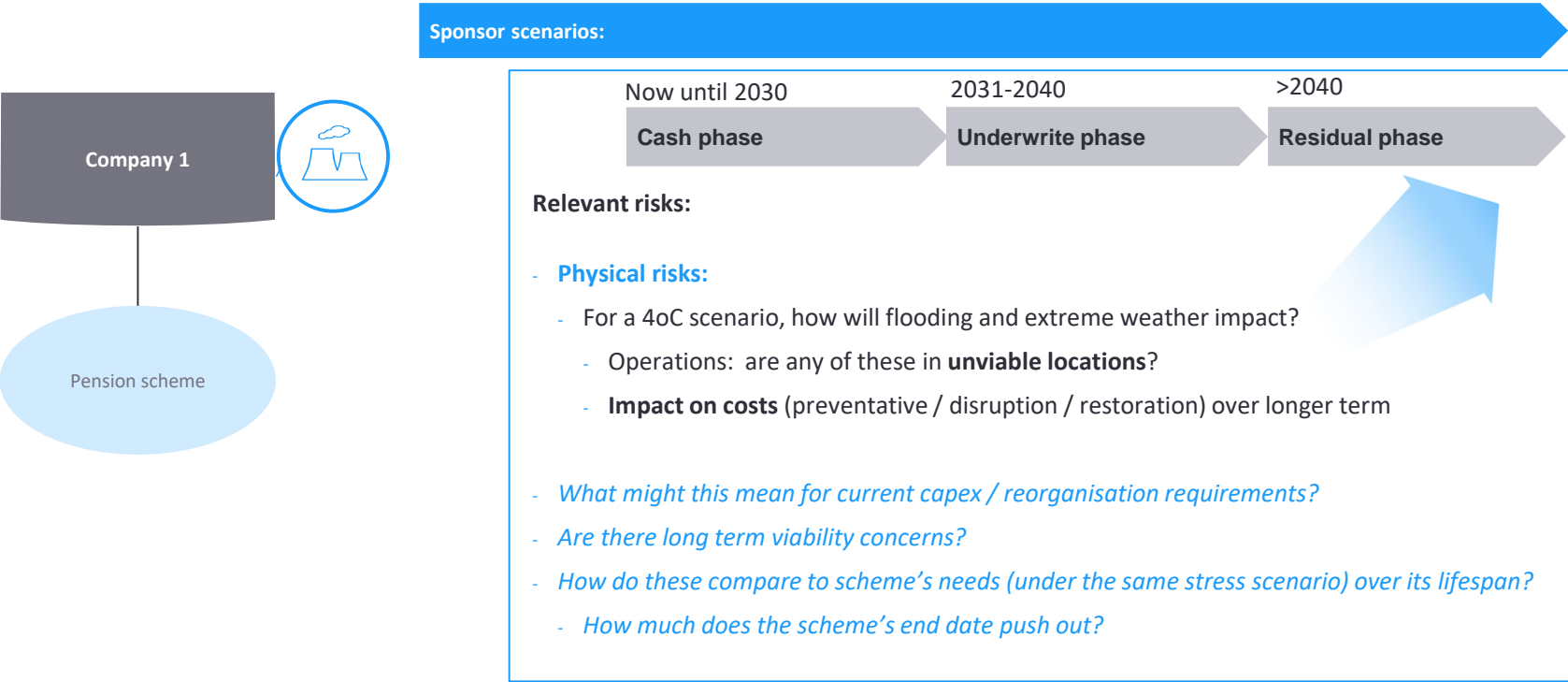
Relevant risks:

- **Transition risks:** e.g. for a 1.5oC scenario, how will a sharp increase in carbon cost and requirement to reduce emissions impact ...
- **Demand** for company's products?
- **Energy and input costs** to make and transport those products?

- *What might this mean for capex requirements?*
- *What might this mean for accessing future finance?*
- *How does this compare to scheme's needs (under the same stress scenario) in those time periods?*

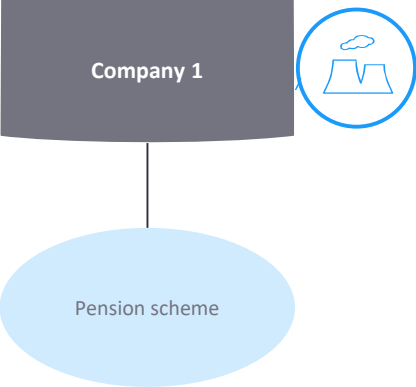
Case study 1

- ▶ Carbon-intensive employer with underfunded scheme



Case study 1

- ▶ Carbon-intensive employer with underfunded scheme



Sponsor scenarios:

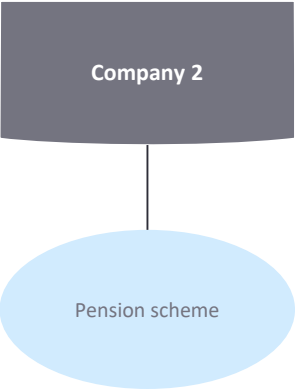
Now until 2030	2031-2040	>2040
Cash phase	Underwrite phase	Residual phase

Resilience

- Where are the pinch points between scheme and sponsor in the different scenarios?
- What mitigations and climate opportunities exist – and how do you want to view those?
- What does it mean for the scheme’s end game?

Case study 2

- ▶ Non carbon intensive employer with well-funded scheme

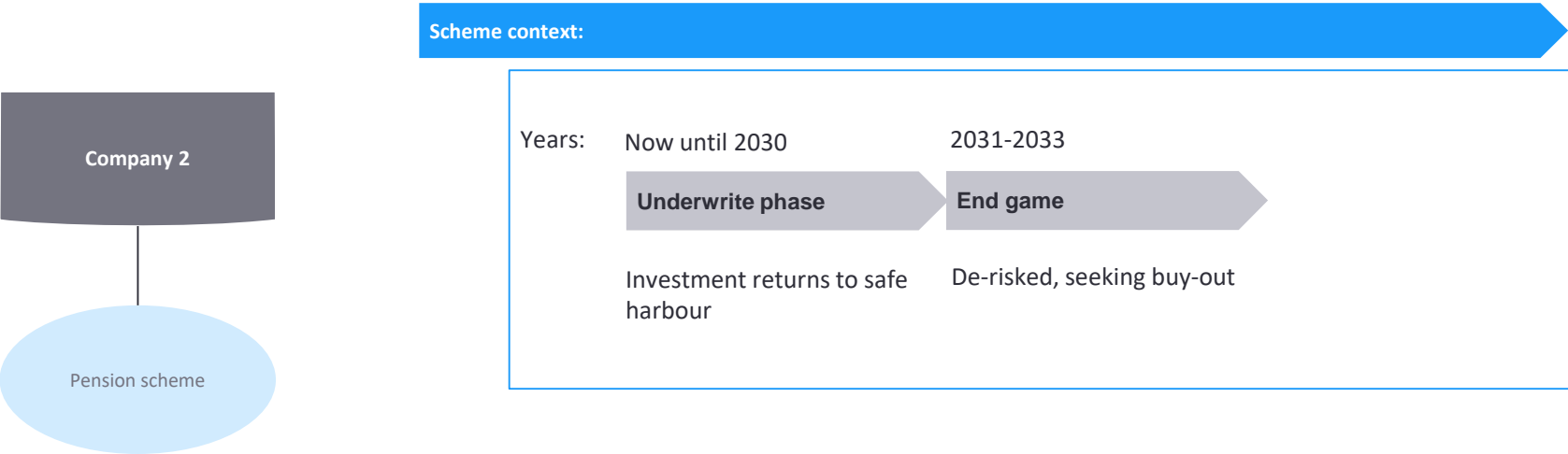


Scheme context:

Years:	Now until 2030	2031-2033
	Underwrite phase	End game
	Investment returns to safe harbour	De-risked, seeking buy-out

Case study 2

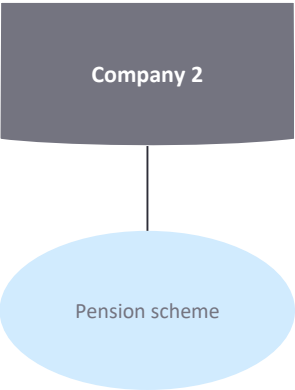
- ▶ Non carbon intensive employer with well-funded scheme



- ▶ Is it still relevant to consider the covenant climate scenarios?
 - ▶ Meeting disclosure requirements in respect of key risks / opportunities
 - ▶ Stress testing assumptions
 - ▶ Establishing how well-equipped management is to address challenges

Case study 2

- ▶ Non carbon intensive employer with well-funded scheme



Scheme context:

Years:	Now until 2030	2031-2035
	Underwrite phase	End game

Relevant risks:

- **Transition risks:**
 - There are costs and challenges associated with all kinds of sponsors in a sharp transition
- **Financing risk:**
 - Access to capital
- **Physical risks:**
 - Less likely to be driver

- Do the costs and challenges of transition disturb the scheme’s journey plan?

- Do the scheme’s needs change under the funding scenarios – e.g. move to a cash need, or push out end game date?

Approach

1 What are the relevant risks / opps?

- ▶ Identify the climate-related risks and opportunities relevant to covenant

- ▶ Management's view
- ▶ Sector analysis
- ▶ Competitor information
- ▶ Independent input

2 How might these impact the sponsor?

- ▶ Scenario analysis:
 - How will those risks crystallise under different climate scenarios
 - Transition scenario
 - Physical scenario

- ▶ Has the company done scenario analysis?
- ▶ **What is the context?** Heavy or lighter touch?
- ▶ Specialist input / critical friend approach

3 What does this mean for scheme resilience?

- ▶ Comparing the needs of the scheme with the performance of the covenant under different climate scenarios

- ▶ Congruence of assumptions
- ▶ Gap analysis
- ▶ How to treat mitigations and opportunities



Chair



Closing
Claire Southern, Hogan Lovells

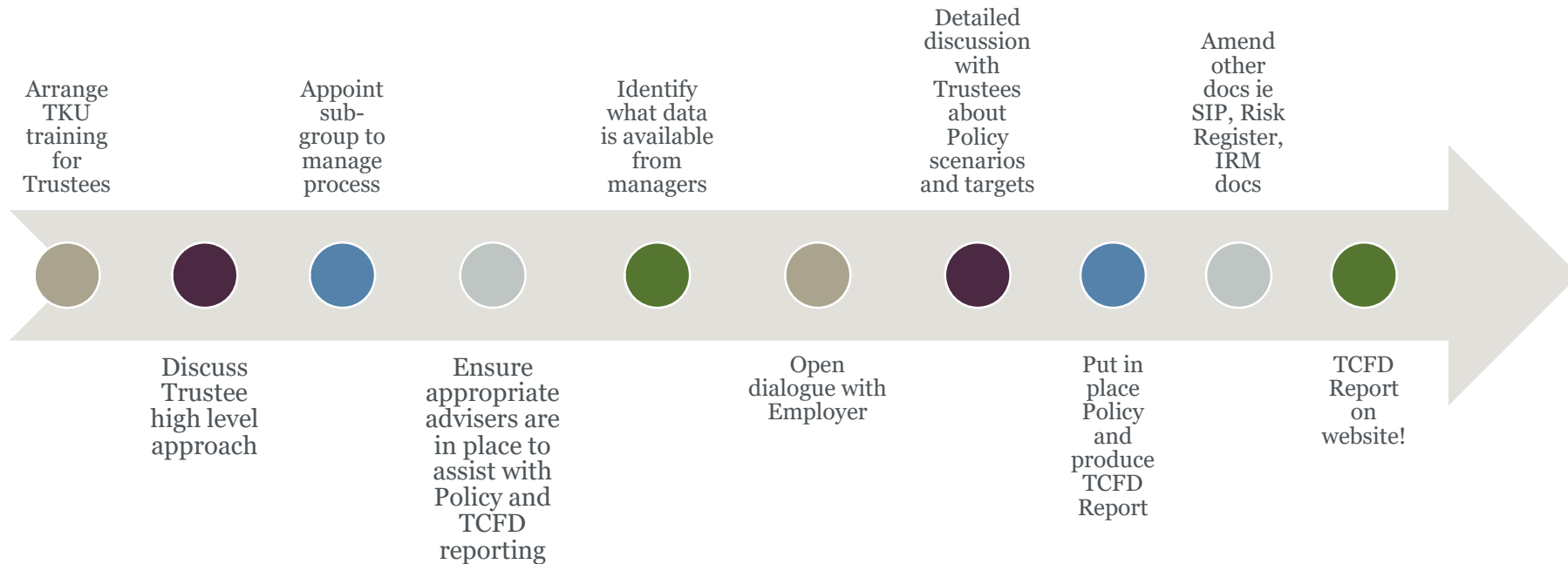
Where does that leave us?



Where do we want to get to?

TKU	Agreed Policy	TCFD Report	Possibly	Employer
<ul style="list-style-type: none">• Trustee board with appropriate TKU• Ongoing TKU updates	<ul style="list-style-type: none">• Policy that articulates Trustee position• Updated SIP (Investment Beliefs and ESG Section)• Updated Risk Register• Updated IRM documents	<ul style="list-style-type: none">• Report that meets requirements ie risks and opportunities, scenarios, metrics, targets, mitigations• Displayed on a publicly available website	<ul style="list-style-type: none">• Changes to investment strategy• Changes to Long Term Plan	<ul style="list-style-type: none">• Employer engaged and contributing to the discussions

How do we get there?



Can decide to do more depending on outcomes of sub-groups work ie changes to investment approach, long term plan for the Scheme



www.hoganlovells.com

"Hogan Lovells" or the "firm" is an international legal practice that includes Hogan Lovells International LLP, Hogan Lovells US LLP and their affiliated businesses.

The word "partner" is used to describe a partner or member of Hogan Lovells International LLP, Hogan Lovells US LLP or any of their affiliated entities or any employee or consultant with equivalent standing. Certain individuals, who are designated as partners, but who are not members of Hogan Lovells International LLP, do not hold qualifications equivalent to members.

For more information about Hogan Lovells, the partners and their qualifications, see www.hoganlovells.com.

Where case studies are included, results achieved do not guarantee similar outcomes for other clients. Attorney advertising. Images of people may feature current or former lawyers and employees at Hogan Lovells or models not connected with the firm.

© Hogan Lovells 2021. All rights reserved.