Aligning your pension scheme with the TCFD recommendations
Quick Start Guide: Scenario Analysis

1. Overview

Carrying out scenario analysis, which may also include stress testing of more extreme climate-related shocks, is a valuable step in trustees meeting their legal duty to manage climate-related risks, whatever the scheme’s size or circumstances. This includes schemes which are planning to wind up within the next few years as climate-related shocks could still affect asset values and insurer pricing over that time period.

Scenario analysis can help test the strategic resilience of the pension scheme to different future plausible climate states.

A range of scenarios should be considered that illuminate the possible impacts of both transition and physical risks and climate-related opportunities. This could include: an orderly transition where the Paris Agreement goal is met; an abrupt transition which also meets the goal but in a sudden or disorderly way; and no transition where the world is on a pathway to 4°C rises by the end of the century.

Climate scenario modelling is inevitably subject to limitations due to the uncertainties and complexities involved. Trustees should not place too much weight on any single set of results, but instead use the analysis as a tool to build understanding of climate risks and make better-informed decisions.

Climate scenario analysis tools and the underlying information are evolving rapidly. Trustees should keep developments under review and consider on an annual basis whether to update their analysis.

2. Getting started

The range of tools available to help trustees is increasing fast. Light touch approaches are possible and may be appropriate for some schemes, such as smaller schemes with limited resources.

The easiest place to start is by asking your asset managers for details of any climate scenario analysis they have carried out and actions taken as a result. This is something all schemes should do. There are also free tools that trustees can use to conduct climate scenario analysis, such as PACTA and the PRA’s stress test. Alternatively, you can ask your consultants or a third-party provider.
Asset managers’ analysis is likely to be carried out at security level (“bottom-up”) for each fund or mandate. Trustees should therefore seek ways of complementing this with consideration of scheme-level (“top-down”) risks that arise from aggregation of portfolio-level impacts, macro-economic impacts and (for DB) covenant and liability impacts. It may be easiest to start with qualitative approaches that describe how climate-related impacts could crystallise over time. This should, however, be followed up with quantitative analysis as soon as practicable.

3. Minimum requirements for large schemes

Subject to consultation and approval by Parliament, regulations will come into force in October 2021 requiring trustees of schemes with net assets in excess of £1 billion, as well as authorised master trusts and schemes providing collective money purchase benefits to:

- As far as they are able, undertake scenario analysis which assesses the potential impact on the scheme’s assets and liabilities of the effects of the increase in temperature and the resilience of the scheme’s investment strategy and, where it has one its funding strategy, in at least two global average temperature increase scenarios, one of which must be a scenario where the increase is by a temperature between 1.5 °C and 2 °C inclusive above pre-industrial levels.
- In their annual TCFD report, describe the potential impacts on the scheme’s assets and liabilities which they have identified and the resilience of the scheme’s investment strategy and, in the case of DB schemes, funding strategy in at least two climate-related scenarios, including at least one scenario with an average temperature rise of between 1.5°C and 2°C inclusive

Scenario analysis must be undertaken in the first year a scheme comes into scope and every three years thereafter. However, in the intervening years, trustees must review annually whether or not circumstances have changed such that they should re-do the scenario analysis before the end of the 3-year period. If they decide not to do so, they should explain why.

These requirements indicate what could be considered good practice for smaller schemes.

4. Best practice

Over time, schemes should seek to address data shortcomings and modelling limitations identified in their initial rounds of climate scenario analysis. Trustees may wish to increase the sophistication and granularity of their modelling, incorporating the latest thinking from across the industry. They may find it helpful to compare results from several different models and increase the number of scenarios considered.
5. Reporting

When disclosing details of the climate scenario analysis they have carried out, trustees should include:

- Details of the scenarios used, methodology and related assumptions;
- The external factors which have limited their ability to do scenario analysis, such as data gaps, and the steps they are taking to address these; and
- Their conclusions regarding the strategic resilience of the scheme and the actions they have taken as a result.