HM Government

Aligning your Pension Scheme with the TCFD Recommendations

Part I - Quick Start Guide

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The Pensions Climate Risk Industry Group

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

1.The financial Risk of climate change

All pension schemes, regardless of size, investments or their time horizons, are exposed to climate-related risks.

Distinct characteristics of climate change that require a different approach1

- **Far-reaching impact in breadth and magnitude:** climate change will affect all agents in the economy (households, businesses, governments), across all sectors and geographies. The risks will likely be correlated and, potentially aggravated by tipping points and non-linear impacts. This means the impacts could be much larger, more widespread and diverse than those of other structural changes.
- **Foreseeable nature:** while the exact outcomes, time horizon and future pathway are uncertain, there is a high degree of certainty that some combination of increasing physical and transition risks will materialise in the future.
- **Irreversibility**: the impact of climate change is determined by the concentration of greenhouse gas (GHG) emissions in the atmosphere and there is currently no mature technology to reverse the process. Above a certain threshold, scientists have shown with a high degree of confidence that climate change will have irreversible consequences on our planet, though uncertainty remains about the exact severity and time horizon.
- **Dependency on short-term actions**: the magnitude and nature of the future impacts will be determined by actions taken today, which thus need to follow a credible and forward-looking policy path. This includes actions by governments, central banks and supervisors, financial market participants, firms and households.

2. Types of climate risk

Transition risks - relates to the risks (and opportunities) from the realignment of our economic system towards low-carbon, climate-resilient and carbon-positive solutions (e.g. via regulations or market forces).

[1] HM Government: Green Finance Strategy – Transforming Finance for a Greener Future (July 2019) - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/820284/190716_BEIS_Green_Finance_Strategy_Accessible_Final.pdf

Physical risks - relates to the physical impacts of climate change (e.g. rising temperatures, changing rainfall, threats from rising sea levels and increased frequency and severity of extreme weather events).

3. The legal requirements on trustees to consider climate-related risks and opportunities

Fiduciary and Trust Law duties

The climate crisis poses a financial risk to all asset owners, but also presents opportunities for investors. Trustees should consider how, and to what extent, it could impact their investments and the necessary actions that arise from that assessment.

Trustees should take advice on their legal duties in the context of specific exercises of investment powers, but may wish to think in terms of three core duties when making investment decisions, as outlined below:

(A) **Exercise investment powers for their proper purpose -** Pension scheme trustees must exercise their investment powers for the purposes for which they were given.[2] The consideration of climate-related risks and opportunities should take place in this context.

(B) **Take account of material financial factors -** Trustees should always take into account any relevant matters which are financially material to their investment decision-making. These are frequently referred to as "financial factors".[3] When considering the financial implications of climate change, trustees should consider the financial implications of both transition risks and physical risks.

(C) **Act in accordance with the "prudent person" principle -** Trustee investment powers must be exercised with the "care, skill and diligence" that "a prudent person would exercise when dealing with investments for someone else for whom they feel morally bound to provide".[4] Standards are evolving in this area and what may be considered "prudent" in relation to climate-related risks today might no longer meet that standard in the future.

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[2] Trustees should be mindful of the different duties applying to defined benefit pension schemes (where the trustee duty is to invest the scheme's assets appropriately to pay the scheme's promised benefits) and to defined contribution schemes (where the purpose of the investment power is to provide a "pot" of money to be used by each member to provide for his or her retirement).

[3] For further detail see the Law Commission's report on the Fiduciary Duties of Investment Intermediaries (July 2014) https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/

[4] Re Whiteley (1896) 33 Ch D 347 at 355

Statutory requirements

Statutory requirements apply to pension trustees in addition to their fiduciary and trusts law duties. Again, trustees should take advice on their legal obligations but should take note of the following regulatory requirements in particular:

(A) Effective system of governance including internal controls - Section 249A of the Pensions Act 2004 requires that the trustees or managers of pension schemes in scope should have "an effective system of governance including internal controls", on which The Pensions Regulator must issue a Code of Practice.[5]

(B) Disclosure of policies in the Statement of Investment Principles - The purpose of a SIP is to set out the trustees' investment strategy, including their investment objectives and the investment policies they adopt. These statutory obligations specifically require consideration of climate change.

(C) Annual Report and Accounts - Trustees should take advice on the content in relation to their particular scheme, although broadly in each annual report prepared after 1 October 2020:

- Trustees of defined benefit schemes must include a statement on how their voting and engagement policies have been implemented.
- Trustees of schemes providing defined contribution benefits are required to include a statement setting out how, and the extent to which, all policies have been implemented.

(D) Pensions Schemes Bill 2021 - Subject to consultation and approval by Parliament, the [Pension Schemes Bill 2021] will introduce new powers for Government in relation to climate change risk.

Proposed regulations[6] will apply to the largest schemes and authorised master trusts from October 2021. The trustees of schemes in scope are required to, among other things:

- implement climate change governance measures and produce a TCFD report containing associated disclosures; and
- publish their TCFD report on a publically available website, accessible free of charge.

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[5] NOTE – At the time of writing the Code of Practice, has not yet been published - https://www.thepensionsregulator.gov.uk/en/document-library/statements/single-code-of-practice-statement

[6] https://www.gov.uk/government/consultations/taking-action-on-climate-risk-improving-governance-and-reporting-by-occupational-pension-schemes

4. The TCFD Recommendations

The TCFD recommendations are structured around four thematic areas that represent core elements of how organisations operate. These might be considered to apply to pension trustees (as asset owners) as follows:

Governance - Disclose the trustees' governance around climate-related risks and opportunities

Strategy - Disclose the actual and potential impacts of climate-related risks and opportunities on the pension scheme where such information is material

Risk Management - Disclose how the trustees identify, assess, and manage climate-related risks

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