Summary

- Although the TCFD itself provides a good framework, compliance with the UK DWP's TCFD regulation has been a steep learning curve for many funds and the response to date has been mixed.
- There is some concern that responses to the regulations risk becoming a box-ticking exercise, focusing attention on establishing processes, collecting data and producing reports, rather than on effective risk management.
- Ahead of the DWP, several observers call for a more streamlined approach that places more emphasis on addressing climate change, and other ESG risks, and supporting the transition to net zero, rather than focusing solely on the reporting process as an end in itself.

TCFD implementation - the story so far

Abigail Williams explores how TCFD regulations have bedded in within the pensions sector

Since the introduction of the Department for Work and Pensions (DWP) regulations in 2021, stakeholders across the pensions sector have been getting to grips with the Taskforce on Climate-Related Disclosures (TCFD) regime.

So, how well has the pensions sector responded to, and implemented, the TCFD recommendations since their publication? And, ahead of the DWP review, which aspects would observers like to see changed?

Steep learning curve

According to the Transition Pathway Initiative chair, David Russell, the TCFD itself provides a good framework for investors and companies to follow in terms of establishing the internal processes to manage the transition to a low carbon future. Even so, he stresses that the UK DWP's TCFD regulation is "very detailed and onerous", so compliance with it has been a steep learning curve for many funds, even those that had previously published TCFD reports, and the resources required to comply with the regulations are "much higher than DWP predicted and are significant, both financial and in terms of personnel time".

"However, many funds have now been through the cycle twice and by and large have done well. I believe only one pension fund has been fined for non-compliance and that was for late online publication of their TCFD report rather than content," he says.

Meanwhile, Hymans Robertson climate change consultant, Amy Sutherland, notes that, overall, the sector has responded well and, despite it sometimes being a 'slog' in terms of time and resources required, all have made the time to meet the requirements.

"Implementation has gone well overall, but there have been a number of sticking points, for instance, emissions data and questions on the realism of climate scenario analysis. Building these parts of the disclosures into scheme's broader strategy has been done, but there is still trepidation around being able to place a degree of reliance on these areas for decision making purposes," she says.

"Additionally, whilst a significant amount of work has been undertaken, one of the points that The Pensions Regulator has highlighted – and something that I believe is still the case – is cascading this information to scheme members in an accessible and digestible way that generates engagement," she adds.

Important catalyst

Taken as a whole, Lane Clark & Peacock partner, Claire Jones, believes the TCFD regime has been an important catalyst for large UK pension schemes to place greater emphasis on climate change, but stresses that there is more to be done in terms of improving their climate risk management and hence delivering better outcomes for members.

In her view, the main benefit so far has been increased knowledge and understanding, among both trustees and advisers, particularly in the areas of climate-related risks, scenario analysis, and metrics.

"Schemes have new governance arrangements in place and have incorporated climate change into some of their scheme processes. However, the regulations and guidance have focused attention on establishing processes, collecting data and producing reports, rather than effective risk management," she says.

"There is some concern that trustees have made relatively few changes in how money is being invested. Part of the reason for that may be the extensive and detailed nature of the guidance, which has led to a box-ticking, compliance mindset," she adds.

For DB schemes, Jones notes that the period since the TCFD regulations came into force has coincided with rising interest rates, rising inflation and the gilts crisis, which has reduced trustees' bandwidth to consider climate change. She also says that many in-scope schemes are mature DB schemes that are looking to buy out the benefits with an insurer in the short- to medium-term, which limits their exposure to climate change and the actions they can take.

"The aim should be to address climate change, and other ESG risks, and support the transition to net zero, rather than a focus on reporting it itself"

"If DWP does decide to extend the requirements to smaller schemes, this should not be done purely based on size, but instead focus on schemes with greater climate risk exposure. For example, those where members are still accruing benefits," she says.

Risk models

Elsewhere, We Mean Business director – net zero finance, Jane Thostrup Jagd, says performance of the climate change governance and reporting regulations in UK to date has been mixed. On the plus side, she notes that reporting now 'rigorously' covers the four elements of the TCFD – including governance strategy, risk management, and metrics and targets – whereas it was previously up to the individual pension company if they wanted to sign TCFD and report accordingly.

"Previously, the reports typically only covered some elements, and often only to a boilerplate stage. In particular, quantification and monetisation have always been the least developed part, both for pension companies but also for all other companies that have claimed to provide TCFD information," she says.

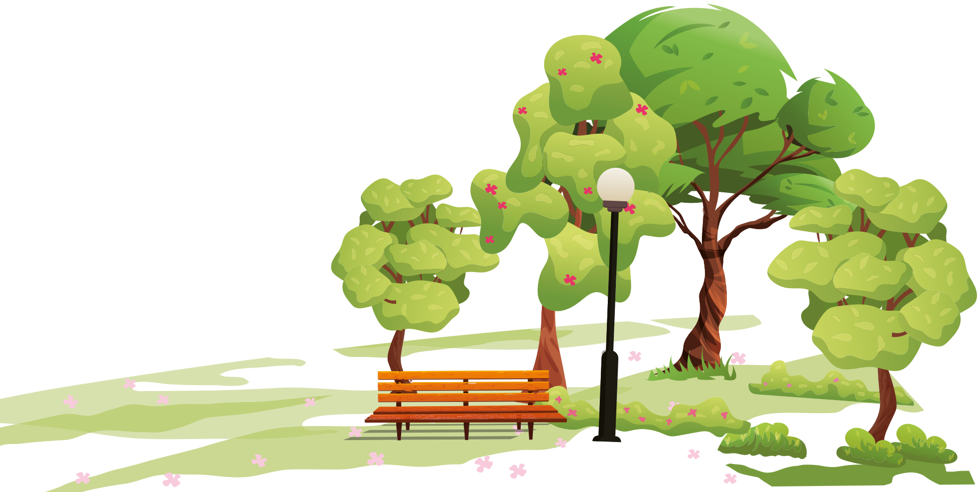
On the downside, Jagd believes a key problem for the users is that reporting is "very much historical", for example focusing on historical greenhouse gas (GHG) reporting, but "TCFD is about the future, scenario work and resilience-testing of the company's finance".

"Historical GHG reporting does not necessarily directly mean anything for the pension savers ability to evaluate the portfolio's climate risk and how well the pension company manages these risks. It is also difficult to compare with the pension company's peers. How does my pension company perform compare to others?" she says.

For the Carbon Tracker Initiative founder and director, Mark Campanale, one of the key elements relating to pension fund reporting against the TCFD guidelines is climate risk scenario stress testing, whether pension schemes believe that their ability to pay benefits in the future is constrained by the impact of climate change.

"We received expressions of concern, privately, from some regulators who were worried that the TCFD-related disclosures they were seeing from pension funds were unusually confident that there would be no major problems in paying the benefits. The damage functions they were using appeared to underestimate both transition risks and physical risks," he says.

"On further inspection, this boiled down to the use of what we believe to be faulty climate risk models. They were using investment consultant's derived risk models that were typically using faulty assumptions – often based on the flawed



integrated assessment models that had classical economists such as Nordhaus's assumptions at their core," he adds.

Forward looking

One thing Jones would like to see moving forward is a simplification of DWP's statutory guidance by streamlining the 54-page statutory guidance to make it shorter, less detailed and more principles-based.

"The aim should be to reduce the length of the reports produced and discourage a box-ticking, compliance mindset," she says.

Jones also calls for a greater emphasis on risk management, moving beyond establishing processes, to effective management of the climate-related risks and opportunities that trustees have identified. This is as well as having less burdensome and more decision-useful metrics requirements, moving to a principles-based approach that allows trustees to focus on the most important mandates and the most relevant metrics for those mandates, rather than requiring four quite-specific metrics for all assets.

"Metrics is an area of the current regulations that is particularly burdensome and the effort required to comply is disproportionate to the benefits for members, particularly given the current challenges around data availability, quality and reporting systems," she says.

"In addition, the guidance around scenario analysis should be updated in light of recent concerns about the shortcomings of quantitative modelling, and I'd like DWP to encourage greater consideration of funding and covenant aspects by DB schemes," she adds.

Now that most pension companies have got the hang of TCFD and know what the regulation requires, Jagd argues that maybe the next thing to consider is the users of the information.

"Consider for instance more forward-looking content, consider useful formats, consider ability to use the information to compare and make investment and portfolio decisions. That was the purpose," she says.

Ultimately, although large funds have largely got the systems in place to comply with the TCFD regulations, Russell argues that smaller funds simply lack the resources to deliver the current regulation, resulting in a licence for service providers to print members' money.

In this light, he believes DWP should consider simplifying the regulations if they are to apply to smaller funds. More focus on how assets are transitioning rather than backwards-looking carbon footprints would also be helpful.

"There is also a significant reporting burden on UK pension funds … which takes time and resource away from actually addressing climate change and other ESG issues. The DWP should work with other organisations that require ESG-related reporting from pension funds – the FRC on the stewardship code, the PRI for its reporting and assessment framework – and review how this TCFD reporting fits into other pension fund reporting to reduce overload," he says.

"And it's worth remembering that the aim should be to address climate change, and other ESG risks, and support the transition to net zero, rather than a focus on reporting it itself, something that seems to have been lost in the drive for increased pension funds transparency," he adds.

Written by Abigail Willians, a freelance journalist