How do pension schemes meet TCFD obligations?

Climate-adjusted analytics are key to mapping pension schemes' climate risk exposures

As momentum behind action on climate change and the journey to net zero builds into COP26 this autumn, UK pension funds have a critical role to play in driving long-term sustainability across the investment value chain.

Across the pensions industry, the focus on climate risk mitigation – and the approach to environmental, social and governance factors more broadly – has ramped up in line with increasing demand from stakeholders and rising regulatory obligations for trustees and fiduciaries of UK schemes.

Since October 2019 ESG factors have been in scope to be considered financially material considerations in scheme statements of investment principles. From October 2021 the bar will be raised again as trustees of plans with more than £5 billion in assets will be required to report on the financial risks of climate change within their portfolios in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). From October 2022, this requirement will be extended beyond the very largest schemes to all pension funds with more than £1 billion in assets. In time, this could also be extended to smaller schemes too.

Climate risk manifests in two ways: physical risk – the first-order risks arising from weather-related events and secondly, transition risk – the risks associated with the transition to a lower-carbon economy. Physical manifestations of our changing climate give rise to more extreme weather, higher average temperatures and rising sea levels, all of which drive short- and long-term investment implications. Advances in climate and data science enable investors to gauge the likely economic impact of climate-related risks on a localised basis and assess the knock-on impacts on portfolios.

The mitigation of physical risks demands action by global governments, regulators and investors, in turn driving 'transitional' risks and opportunities across the global economy and markets, through increasing regulatory action and technological innovation.

It is near inevitable that climate change risk and transition impacts will lead to re-pricing in financial markets and long-term portfolios.

Today, many defined benefit schemes are building strategic endgames to delivering pension payments over the next 10, 20 or 30 years, and trustees must factor in both major structural shifts and the more idiosyncratic factors that may impact asset values and, ultimately, threaten the sustainability of pension promises.

As such, it is necessary for schemes to account for both physical and transitional risks in building a holistic picture of their portfolio's climate risk exposures. The task of collating information across portfolios and extrapolating climate risk across asset allocation, duration and sector exposures demands complex modelling and data analysis. We will also be re-optimising our strategic asset allocations using our new climate aware capital market assumptions. This means that our assumptions, and therefore strategic asset allocation, will now explicitly incorporate the impact of climate change.

Across portfolios, investment and risk managers require climate-adjusted analytics to compare and contrast against standard datasets to support their decision-making. By bringing together climate science with asset-specific modelling, asset owners can derive a set of climate-adjusted security valuations and risk metrics, which can then instruct ongoing progress towards reducing the carbon intensity of portfolios. The powerful combination of climate science and asset specific modelling, coupled with the benefits of delegating responsibility to a fiduciary manager to help manage risks and adjust asset allocation accordingly, can revolutionise the way trustees assess risk across portfolios today – and limit the risks of tomorrow.

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