PCRIG guidance to help trustees align with TCFD: Our detailed response to the consultation

Link to proposed guidance

The question numbers are the same as those used by PCRIG in their online response form. Questions 1-3 are for name/email/organisation so have been omitted.

4. What do you like about the guidance? / What is most useful?

Part I gives a good summary of why trustees should care about climate change and what it could mean for pension schemes. The section on legal requirements is a welcome reminder of trustees' fiduciary duty and reinforces that climate change is a material financial risk just like the many other risks trustees are well versed in managing like longevity, interest rates, inflation etc.

The recommendations in Part II are generally very sensible and we support them.

Appendix 2 (Enquiries to make of asset managers) contains very useful questions and will be of immediate practical benefit to trustees. We would like to see this section expanded to cover questions to ask of consultants and advisors.

The Quick Start Guide provides a good summary of the recommendations in the main guidance. Given the length and detail of the main guidance we suggest that the Quick Start Guide should be more prominently mentioned and potentially expanded to be more practical. It may be better for trustees to start with the Quick Start Guide and consult the full guidance when needed, rather than ask them to read the full document. It would also be sensible to help identify which sections are the highest priority for trustees and which may be more useful for advisors or specialists.

5. What don't you like about the guidance? / What needs improving the most?

Whilst the guidance includes comments on “how to use it”, we believe that the sheer length and technical detail contained within the document will be a barrier to many. Given that, we wonder if the guide is intended more for advisors than trustees? Whilst the Quick Start Guide is useful, we do believe there may be merit in some form of middle ground between the two.

Many of the recommendations focus on passive activities like disclosure, analysis, understanding and considering. Given the ultimate policy objective is to drive change in trustee actions (which will not happen through disclosure alone), we would like the guidance to better detail the practical steps that trustees can take once they have considered climate risks, e.g. more case studies showing what schemes have done using the results of modelling or analysis.

The guidance is mainly focussed on how climate risks affect investments, with only brief mention of sponsor covenant for DB schemes. There is no mention of the impact on contribution strategies or endgame objectives (DB schemes) or plan design (DC schemes).

6. Is the current structure helpful?

Yes, although we note our separate comments on the barrier created by the length of the document.

7. Does this guidance provide schemes with everything they need to: a) manage climate risks b) disclose in line with the TCFD recommendations?

We do not believe it possible to completely manage climate risks, and we would not expect any single piece of guidance to provide everything a pension scheme would need to try. However, the guidance does cover a lot of useful topics.

8. Have we missed anything?

The guidance is aimed at private sector pension schemes although it is acknowledged that it will be 'of interest' to the managers of funded public sector schemes. We believe that nearly all the principles apply equally to public service schemes and that this should be more clearly stated.

We would welcome more directive comments in Part I to highlight that, where schemes work through the different areas of the guidance, the expectation is most schemes will identify areas where their approach to climate risk could and should be improved, e.g. by employing more robust mitigation strategies. We believe it is important to draw out that the current industry "business as usual" approach is unlikely to be sufficient in the future so schemes should expect to amend their approach, rather than seeing the guidance as a disclosure exercise.

Finally, we note there is a section on 'Additional points for defined benefit schemes'. We would support the inclusion of a similar section on 'Additional points for defined contribution schemes' to highlight areas of importance in a DC environment, for example member engagement, provider evaluation, member education and tools for members.

9. Part I - Please provide any comments on "Introduction - Understanding climate change as a financial risk"

We agree that climate risks will affect pension scheme investments and (for DB schemes) sponsor covenant, and that these are the most significant areas for concern. The guidance does not mention the impact on DB scheme liabilities, for example through higher inflation or changing life expectancy.

We agree with the general outline of how climate risks affect pensions schemes, including the idea that the policy response (when and how strong) will have an important impact on pension schemes (page 17). We have used this argument to devise the scenarios in our own climate risk modelling.

10. Part I - Please provide any comments on "The legal requirements on pension trustees"

We find this section helpful that it clarifies how taking account of climate change risk (as a material financial factor) is likely to be entirely consistent with the principle of fiduciary duty. We particularly welcome the comments in 3.2(C) on the changing nature of prudence and that the actions that may be considered appropriate today may not be so in future. We would like to see this given greater prominence, highlighting to trustees that their need to address climate risk must be an ongoing process.

11. Part I - Please provide any comments on "The TCFD Recommendations"

In paragraph 52, the comment on strategy that trustees could "Disclose the actual and potential impacts of climate-related risks and opportunities on the pension scheme **where such information is material**" is somewhat ambiguous in its intent. The same is true of the comment on "metrics and targets". The purpose of disclosure is for the benefit of the end-user and to suggest that disclosures are only appropriate "where material" does not address the process by which trustees may have arrived at a decision on materiality.

12. Part II - Please provide any comments on "Defining climate-related investment beliefs"

We are very supportive of the concept of trustees taking time to develop their investment beliefs, including how they relate to climate change risks. Appropriate training is of course essential to doing this effectively.

Paragraph 63 says "Clarifying the trustees' position on climate change considerations as part of the trustee fiduciary duty" which suggests that climate may be legitimately considered otherwise. Is this what is intended?

Paragraph 63 also refers to the balance between engagement, voting and divestment which is an equity-centric view. It would be good to also include an example here that references the fact that many defined benefit pension schemes have lower equity allocations and the consideration of climate risk within a debt context.

We note that the section is entirely focussed on investment beliefs, but that employer (and maybe even employee) contributions are an important part of funding for many schemes. We would like to see a section recommending that trustees set out their beliefs on how the burden of tackling climate risks should be shared between investment strategy and contribution strategy, fully expecting that investments should take the lion's share.

13. Part II - Please provide any comments on "Climate-related risks in investment strategy and manager selection"

We would note that when considering risk appetite with regards to climate risk, consideration should be given to the sponsor's exposure to similar risks. For example, it may be inappropriate for the trustees to accept certain risks associated with the transition to a low carbon economy if the sponsor covenant is also highly exposed to the same risk.

We welcome the requirement to use scenario modelling and have several further technical comments on this which we have included in answer 17 below.

In general, we support the use of scenario models but caution that the model output should rarely if ever be used in isolation as the basis for trustees' decisions. Understanding the assumptions and limitations of modelling are especially important when considering climate risk, where modelling techniques are at a relatively early stage of development and the purpose of such modelling should be to highlight uncertainties.

We agree that trustees should set specific objectives on climate risk for their consultants and by implication, trustees would be expected to use consultants' capabilities with regard to advising on climate change in their evaluation of consultants' performance. Where trustees employ fiduciary managers, the consideration of ability to advise on climate risk is potentially of greater importance given some fiduciary managers make use of in-house asset management capabilities. The guidance should draw the distinction more clearly and place greater emphasis on the need to understand climate risk as part of the appointment and evaluation process.

In paragraph 79 there is some discussion of how risk can be measured relative to benchmark indices. We would welcome a more fundamental consideration of how risk is defined and measured, as simply monitoring performance versus a benchmark can encourage short-termism and lead to poor outcomes.

In paragraph 85, in passive strategies, we would suggest it sensible to reference the guideline relating to the implementation of any index strategy as some will permit the manager to divest where engagement is unsuccessful while others may be more rigid.

14. Part II - Please provide any comments on "Stewardship on climate issues"

Effective stewardship has the added benefit of potentially increasing member engagement, for example, by allowing trustees to communicate the actions that have been taken by investment managers. This is particularly relevant for DC schemes where there is strong evidence that effective communication of responsible investment practices increases confidence in the arrangements. We believe it worth highlighting this point as a potential output of stewardship activity.

15. Part II - Please provide any comments on “Additional points for DB schemes"

We are very supportive of the need to take account of how climate risk could affect sponsor covenant, particularly as this can be neglected in favour of focussing on the risk to schemes’ investments.

We are however concerned at the manner in which section 8.2 is written, being structured as guidance targeted at actuaries, rather than trustees (for whom the guide is written). Whilst we would expect actuaries to become familiar with the guidance in due course although, for consistency, it would be sensible for this section to be clear on what the expectations are of trustees in how they engage with their actuary.

Further, in our view, the positioning of paragraph 110 is perhaps unduly positive as we expect the example described is likely to be true only in the minority of cases. We would therefore suggest switching the order of paragraphs 111 and 110 and noting that the example described in the current 110 is likely to be the (current) exception, rather than the rule.

It may also be worth clarifying that the ‘more prudent funding approach’ mentioned in paragraph 111 can manifest itself in a number of ways and does not solely imply amending assumptions (noting that tinkering with assumptions will not in itself lead to better climate risk management). For example, it could mean more prudent assumptions / higher funding targets, a shorter recovery plan, more reliance on contributions relative to investment returns etc. Ultimately the objective should be that trustees set funding strategies which take into account the climate risks to which they are exposed.

We note that buy-out targets are mentioned in the context of potential price implications should insurers start to price-in climate impacts. Given buy-out is likely to be the end goal for most private sector DB schemes, we believe this section should comment on the need for the trustees of schemes approaching buy-out to investigate the financial strength of the insurers potentially taking on the liabilities, particularly where they also have significant exposure to climate risk through other parts of their business.

Some schemes on the other hand will be targeting a self-sufficiency run off approach. In this case, given the extended timeframes, particular care should be given to the impact of climate risk on the level of self-sufficiency reserves required and it may be worth addressing this specifically.

Public sector schemes are expected to remain open to new entrants and therefore have the longest timeframes of all - even if the guide is aimed at private sector schemes it could be worth making this point.

The suggestion to consider the funding position using a range of assumptions in welcomed but this should extend to recovery plan modelling and future projections.

Even where climate risks are well managed, it is unlikely that schemes will be fully protected over the course of their remaining lifetime. We would therefore suggest that contingency planning should be mentioned in this section to ensure that climate-related downside scenarios are explored and contingency plans agreed with scheme sponsors should these arise in the future.

16. Part II - Please provide any comments on “Reporting and member communications”

We note that the question of “who” climate related disclosures are likely to be written for is not addressed in the guidance. To be clear, we support disclosure as a means of driving forward trustee adoption of best practice in integrating climate risk in decision making. However, TCFD disclosures in their ultimate form are unlikely to be targeted at members who would typically receive such reporting in a shorter, digestible form. We therefore believe the likely users of TCFD disclosures will be (a) other pension funds as a means of benchmarking practice; (b) regulators as a means of assessing industry progress, and/or (c) NGOs as a means of exerting pressure on pension funds to improve practices.

Against this expectation (which we believe the guidance should state) the principles for disclosure are largely sensible although we note the references to members in Principles 1 and 4 – we believe the reference in each case should be to users.

We would note the following practical challenges with the principles for effective disclosures:

- Disclosures should be consistent over time – we anticipate that the industry approach to climate risk will develop over time given, for example, availability of data and the development of methodologies and metrics. We would therefore consider it desirable that the disclosures evolve to make use of improved information and analysis as it becomes available.
- Disclosures should ideally be comparable – at the outset we anticipate schemes will take their own approaches which makes comparability challenging. Over time there may be some convergence towards a more standard approach.

Given the above, it should perhaps be acknowledged that some of the principles may be challenging in the early years of disclosure.

We also note the suggestion of triennial disclosures being more appropriate at the outset. Whilst this may be appropriate for small schemes, in our view annual disclosure is likely to be more appropriate noting that the initial process may highlight areas where trustees approaches could be improved and it would be preferable to ensure annual progress rather than wait for three years to undertake a further review.

17. Part III - Please provide any comments on "Scenario analysis"

In general, we are very supportive of the use of scenario modelling to investigate climate risk, and have used it ourselves for DB and DC pension scheme clients in the public and private sectors.

We have some specific comments on some elements of the guidance:

- Paragraph 141 mentions the uncertainty inherent in long-term modelling and explains that the purpose of it is to inform rather than forecast – we feel this is important enough to include in the chapter summary. Without these kinds of caveats modelling is often regarded as being more objective or more credible than is justified.
    - For the same reason we would also like to see more case studies showing what decisions have been made based on scenario model results, or what specific questions a model was used to answer. Examples would help to illustrate how model results should be used and by extension what they cannot be used for.
    - For example, trustees could decide to change their investment strategy if scenario modelling showed that the outcomes in the most pessimistic scenario were too far outside their risk tolerance. These kinds of things are only mentioned in section 10.10 but we feel they deserve a more prominent position.
- We agree with how the introduction describes the uses of scenario modelling, but we suggest that it also say what the modelling *cannot* be used for. For example, it cannot in itself tell trustees what investment strategy to use, and they can't use it to completely insulate themselves against climate risks. We find that in general trustees, scheme managers and consultants can sometimes be too reliant on model outcomes, without properly considering the factors that the model cannot allow for when interpreting the outputs.
- The guidance should make it clear that any modelling the trustees commission already implicitly includes at least one climate change scenario, even when no explicit mention of it is made. Not making any allowance for climate risk is one of the scenarios that should be considered, perhaps as a baseline for comparison purposes.

- The three scenarios suggested in section 10.4 are not consistent with the comments in section 2.3 on page 17 that a policy response is 'inevitable' and that the current expectation is for 3°C of warming.
- We fully support the comments in section 10.6 around including the impact on scheme liabilities as well as assets, including the effect on longevity. The liability impact is often overlooked in favour of the impact on assets.
- The guidance focusses extensively on the modelling as an end in itself, and we believe there should be greater emphasis on how to use modelling to make decisions. This should include:
  - Decide on the objectives of the modelling – e.g. is it purely to investigate risk and aid disclosure, or is it to inform investment or funding strategy decisions. What, if anything, will be done differently depending on the model results?
  - Understand what features have not been modelled and how to interpret the results given these limitations.
  - Test how sensitive the model results are to different investment and funding strategies (as well as different climate scenarios), to see how much impact the trustees can have on the outcomes.
  - Agree standard metrics that can be used to compare the different climate risk and/or investment/funding scenarios. For example, what time horizon to look at and what measure to use (likelihood of being fully-funded, downside risk, likelihood of contribution increase, etc)
  - As mentioned above, a case study would be a helpful way to illustrate some of these points.

18. Part III - Please provide any comments on "Metrics and Targets"

No comments.

19. Part III - Please provide any comments on the appendices

The list of questions in Appendix 2 is detailed and comprehensive. We suggest that a useful addition to the guide would be to add questions for trustees to ask of consultants and fiduciary managers.

20. Please provide any comments on the Quick start guide

We are generally very positive about the Quick Start Guide and feel it provides a very good summary of the guidance as a whole although, as noted, we suggest that this could be expanded slightly to become the primary point of reference for trustees.