XPS Group

How pension schemes have developed their net zero strategies

TCFD in review – Year 3

March 2025

Contents

Executive summary

Climate change continues to be a prominent area of discussion in politics and financial markets, and the negative impact of climate change is increasingly evident in real time around the world.

The Task Force on Climate-related Financial Disclosure (TCFD) framework aims to improve reporting and drive action to address climate risks and steer entities into opportunities. 2024 was the third year that mandatory TCFD reporting has applied to pension schemes, and this report is our third review of a sample of reports across schemes totaling approximately £400bn of assets summarising the key trends and learnings. Throughout, we have reviewed the approach taken by the largest ‘Wave 1’ £5bn+ schemes who have been required to report since 2021, and ‘Wave 2’ smaller £1bn+ schemes who were brought within scope in 2022.

Key findings

75%

75% of Schemes have adopted Net Zero targets

96% of Wave 1 have set a Net Zero target compared to 56% of Wave 2, with a larger increase versus last year seen from Wave 2. The credibility of these targets has also improved, with 75% of all schemes with Net Zero targets indicating clear plans aligned to best practice such as the Institutional Investors Group on Climate Change (IIGCC) Net Zero Investor Framework.

69%

69% of schemes have made a change in asset allocation to address climate risks

87% of Wave 1 and 52% of Wave 2 schemes have adopted ‘climate-aware’ strategies to support their broader objectives, a significant increase on previous years suggesting the climate risk analysis is driving change in investment decisions.

42%

42% of all schemes indicating some direct investment in climate solutions.

We suspect this will increase year on year as the opportunities and availability of low carbon solutions (such as renewable energy and natural capital) increases over time as new research and development evolves.

2.4°C

Implied Temperature Rise suggests significant portion of assets at risk

The average Implied Temperature Rise of the schemes reported was 2.4°C. This is lower than the latest scientific estimates of global progress (2.7°C), but above the Paris Agreement goal of keeping global warming at least below 2°C, suggesting schemes are holding assets at risk of value deterioration as the transition accelerates.

50%

50% of schemes set targets for transition alignment

65% of Wave 1 and 35% of Wave 2 have set targets on transition alignment, an increase on last year. 85% of schemes have reported being successful against the target they set last year.

Actions for schemes

1	**Consult your advisers** in advance of preparing your next TCFD report to think about ways to enhance your climate strategy.
2	**Set ambitious targets** around climate transition alignment, and consider if there is scope to invest in climate solutions which can help manage systemic climate risk in your portfolio, but also act as a source of long-term opportunity.
3	**Act on the results** of the reporting; identify your highest risk holdings and engage with your consultants and investment managers around what can be done to mitigate those risks. Take targeted action to address risks and opportunities.

It's good to see pension schemes putting more focus on forward looking metrics and targets, with transition alignment now being a key aspect of lots of Net Zero strategies.

Alex Quant
Head of ESG Research

Introduction

2024 has been confirmed as the first year in which the average global temperature increase relative to pre-industrial times exceeded 1.5°C. Furthermore, we have seen significant setbacks for the low carbon transition at a government and industry level, most notably Donald Trump stated he will withdraw the US from the Paris Agreement and pull back on green policies, and many large US institutions have withdrawn from Net Zero initiatives.

The 29th Climate Change Conference of Parties (COP29) in Azerbaijan established a new global climate finance target and saw many countries, including the UK, strengthen their national commitments around climate change, but many felt the announcements and pledges did not go far enough.

In the short term, the recent wildfires in Los Angeles should be a wake-up call, emphasising the urgent need for climate action and the financial consequences of inaction on society and businesses of inaction. Whilst the low carbon transition is not evolving at the pace required, the long-term picture is unchanged: physical and transition risks associated with climate change will be dominant factors in investment markets, it will simply depend on the pace and direction of the transition that informs which of those risks are most material. Either way, climate change will create significant financial risks for those investors who do not take climate risks into account.

In this report we present analysis across a sample of 48 scheme TCFD reports covering c.£400bn AUM to review their approach to climate change risk management and reporting, as summarised below:

		# Schemes	AUM (£)
Wave 1: Those schemes with assets >£5bn at March 2021	Required since Oct 2021 Third report in 2024	**23**	**£359bn**
Wave 2: Those schemes with assets >£1bn at March 2022	Required since Oct 2022 Second report in 2024	**25**	**£51bn**

Note:

AUM of schemes will change year on year, but we have continued to consider the split of schemes based on when they were first required to undertake TCFD reporting. This is not all the TCFD reports available, but a selection to provide an illustration of market trends.

1. Three quarters of schemes have adopted net zero targets

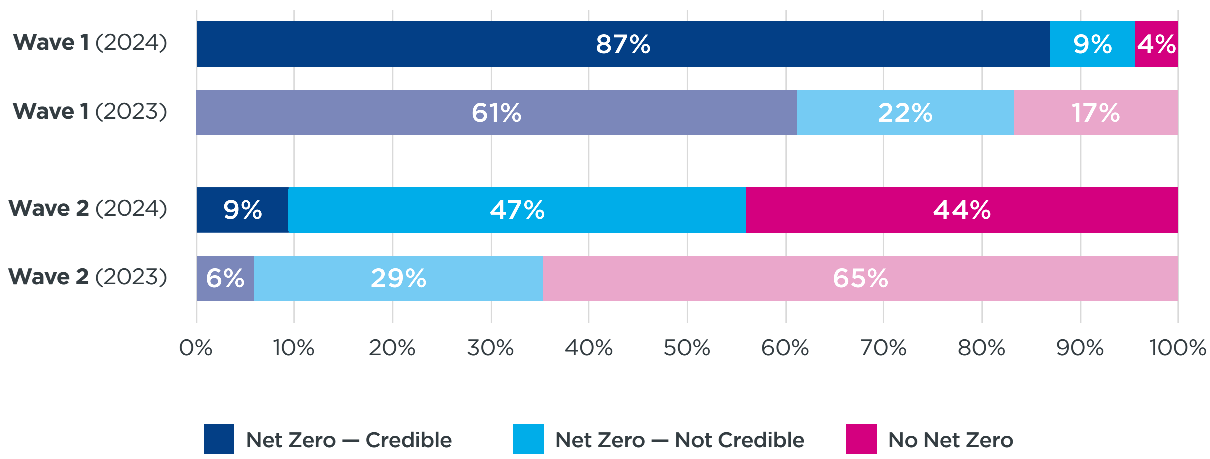
The proportion of Schemes setting a Net Zero target has increased during the year to 96% (2023: 83%) for Wave 1 schemes and 56% (2023: 41%) for Wave 2 schemes.

As part of our review, we also consider how 'credible' the Net Zero strategies are. As part of this we look for evidence of aspects supporting the overall target which are aligned to well-established Net Zero frameworks such as the IIGCC Net Zero Investor Framework. This should include evidence of:

- shorter-term, interim carbon reduction targets;
- focus on transition alignment as well as emissions reduction;
- plans for engagement with the highest issuers;
- evidence of change within the investment strategy to support the Net Zero goal.

Claims of Net Zero 'ambition' without tangible plans or actions were not deemed credible. It was encouraging to see that as well as the overall % of Net Zero targets increase, the % of those which were deemed by XPS to be credible increased, suggesting that TCFD reporting and the discussion around climate change is leading to action in practice.

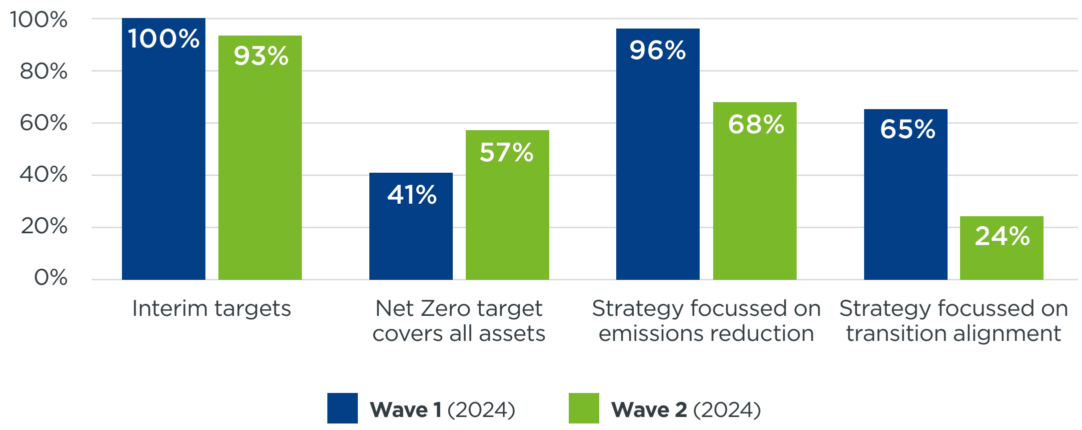
Proportion of schemes with a credible Net Zero strategy



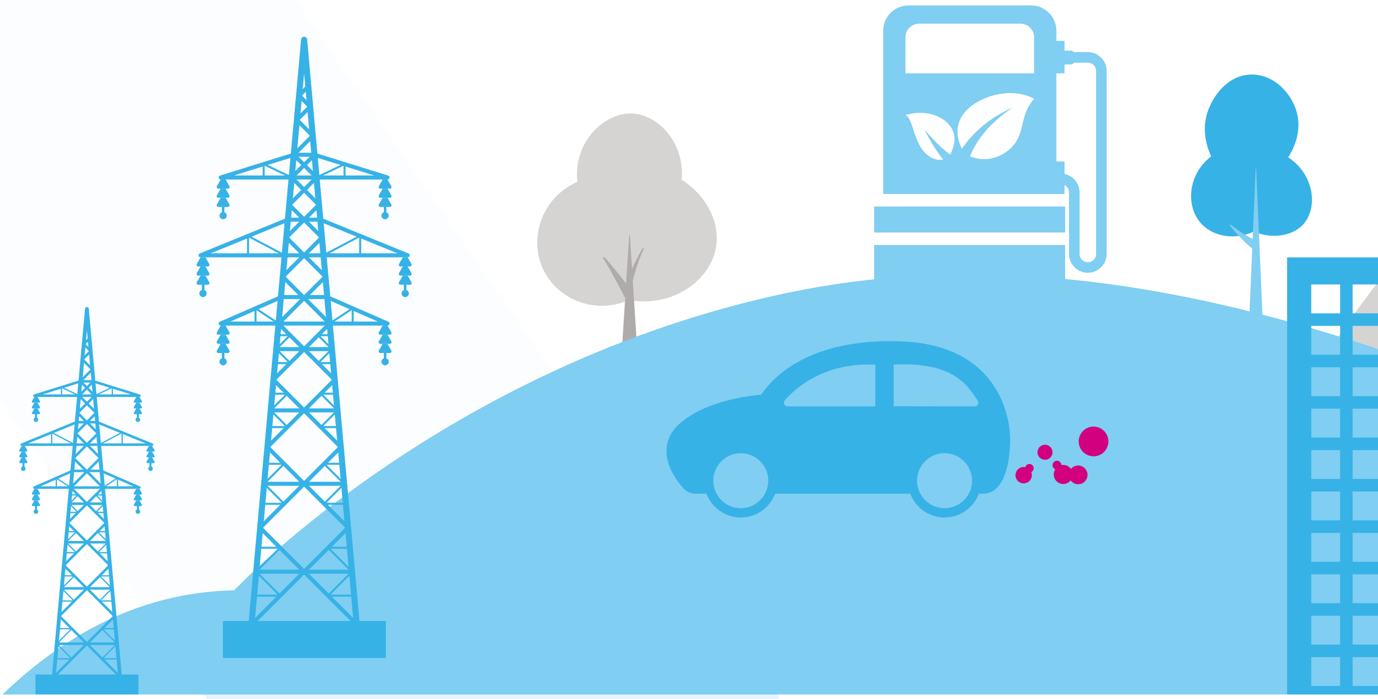
Source: XPS review of sample of publicly available TCFD reports

In the chart below we drill into some of these aspects. Interim targets were common across all schemes. A common area for improvement would be to ensure the Net Zero target covers all asset classes held, which we appreciate may be difficult given the lack of data coverage for certain assets classes. In addition, we hope to see more Net Zero targets with a focus on transition alignment in addition to carbon emissions reduction targets.

Aspects underpinning overall Net Zero targets



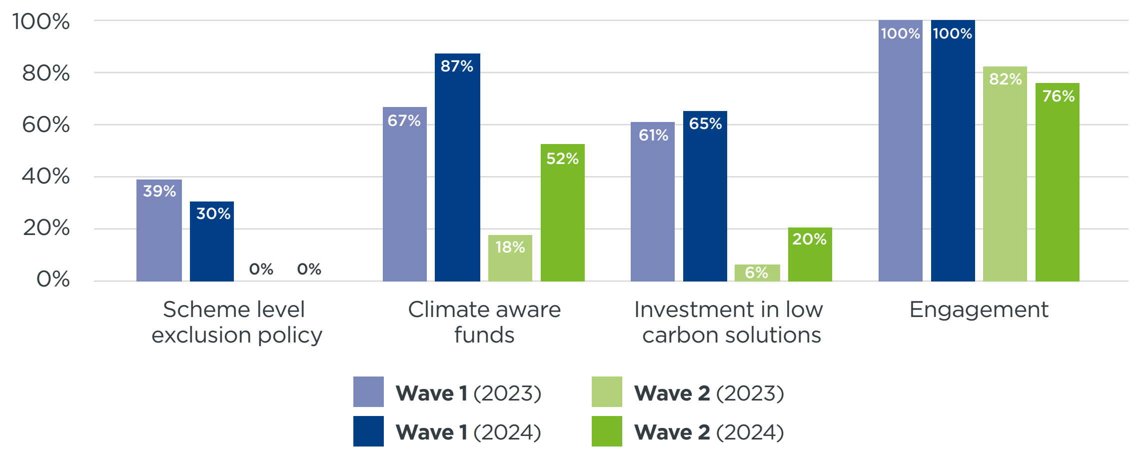
Source: XPS review of sample of publicly available TCFD reports



2. More schemes taking action to address climate risks

The chart below summarises the approach taken by the schemes to address climate risks (this covers all schemes reviewed, including those that have or haven't set Net Zero targets).

Action taken to address climate risks



Source: XPS review of sample of publicly available TCFD reports

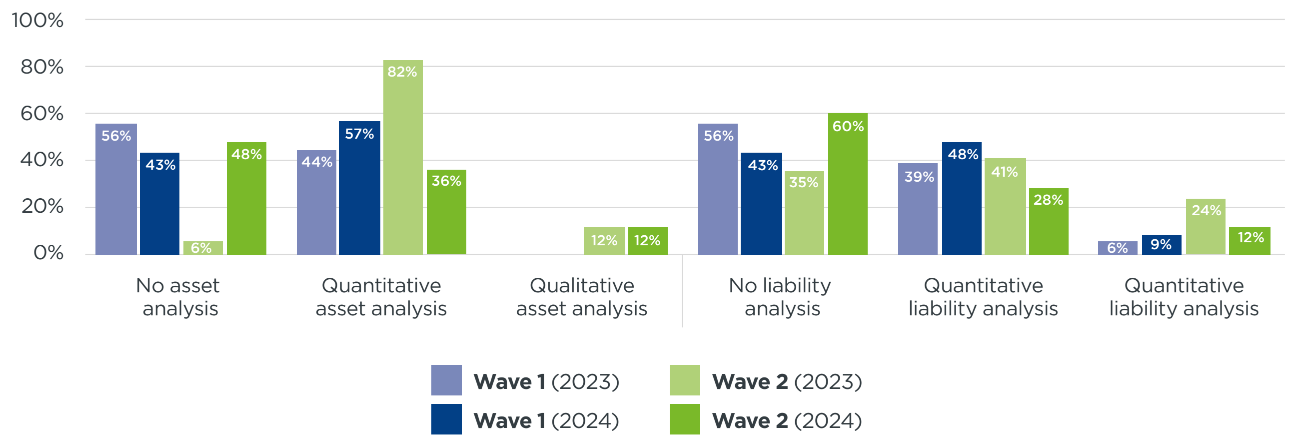
Engagement is still the primary mechanism for addressing climate risk, however the % of schemes that invest in low carbon solutions and climate aware funds has increased during the year.

COP29 highlighted the long-term focus on renewable energy projects and other low carbon solutions available to investors to help facilitate the global transition away from fossil fuels. Natural capital solutions will be well-suited to longer-term investors seeking to benefit from the expected rise in carbon pricing, at the same time addressing biodiversity loss as part of their Net Zero strategy.

Lack of meaningful conclusions from scenario modelling

Given TCFD only requires schemes to undertake scenario analysis every 3 years, we saw only 57% of Wave 1 and 52% of Wave 2 schemes choose to undertake analysis again in their latest report, with most saying there had been no material changes to their strategy or to the quality of the analysis available.

Quantitative or qualitative scenario analysis



Source: XPS review of sample of publicly available TCFD reports

For those schemes that did undertake scenario analysis during the year, the vast majority continue to take a quantitative approach. In line with previous years, it was not clear that schemes were drawing meaningful insights from the scenario analysis or taking action directly as a result of the modelling.

Given the well-documented drawbacks in quantitative climate scenario modelling, notably the disconnect between projected scientific outcomes around climate change and the impact on financial markets, alternative approaches have been developed. In particular, the University of Exeter and USS pension schemes have developed a set of scenarios which are intended to provide more meaningful "real world" perspective over short-term timeframes to prompt action. Only 8% of schemes adopted this approach to scenario modelling.

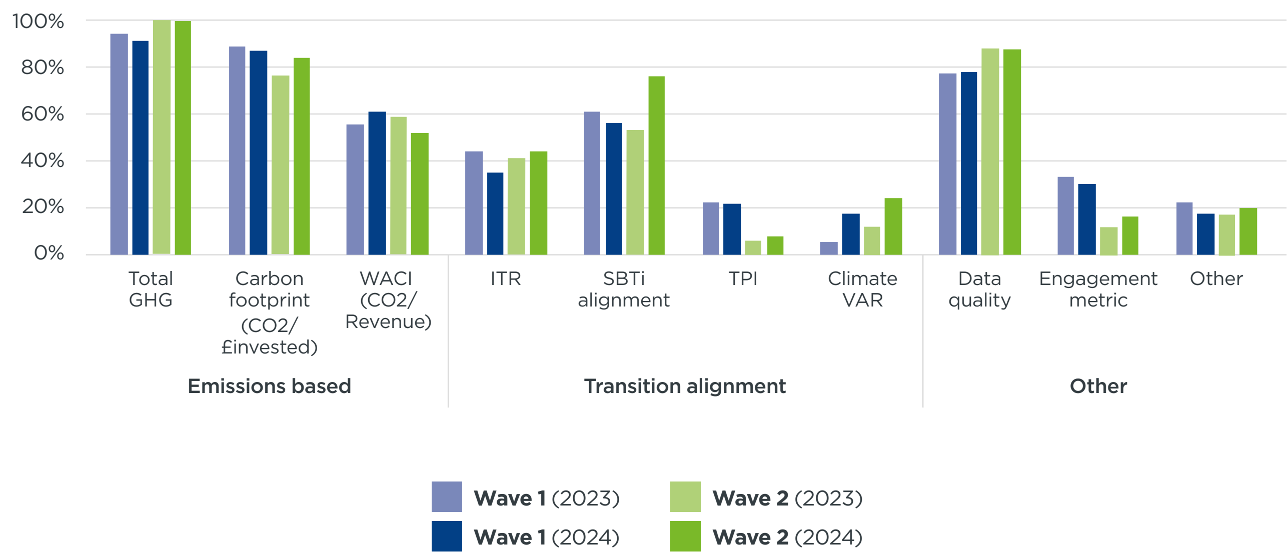
Many schemes will be updating their scenario modelling in 2025 given the minimum 3-year time frame. The Pensions Regulator has suggested that a qualitative approach based on clear narratives might produce more meaningful results compared to quantitative analysis, so it will be interesting to see whether schemes doing scenario modelling will move towards a qualitative approach based on shorter term scenarios.

3. Increased focus on transition alignment

More schemes targeting transition alignment this year

We see that when selecting the required transition alignment metric, most schemes chose to report on the % of portfolio with verified climate targets under Science Based Targets Initiative (SBTi). This was a significant increase on last year for Wave 2 schemes.

Metrics disclosed by schemes



Source: XPS review of sample of publicly available TCFD reports

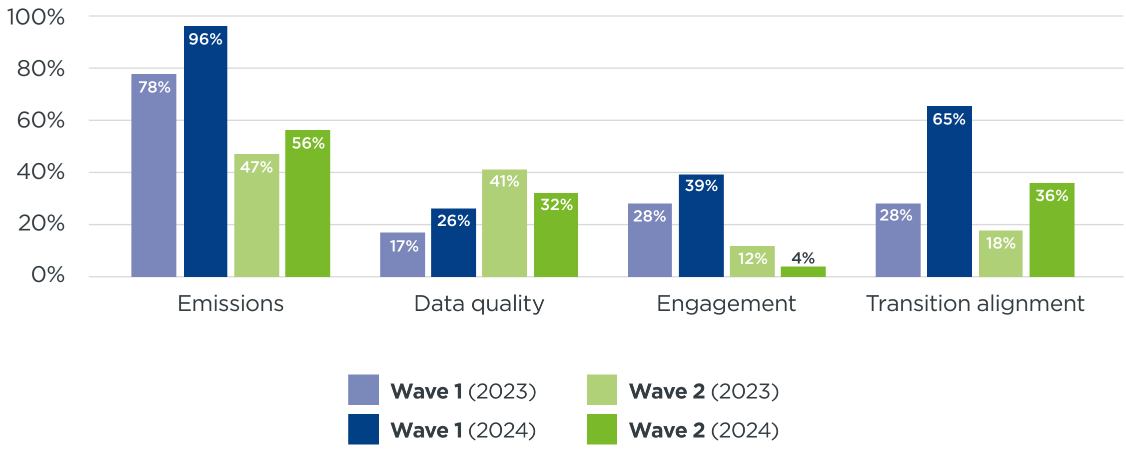
Note:

- ITR = Implied Temperature Rise
- SBTi = Companies with approved targets under the Science Based Targets initiative
- TPI = Transition Pathway Initiative, industry body which assigns a score based on company transition credentials
- ‘Other’ includes exposure to sources of physical risk, funds with ESG tilting, exposure to low carbon solutions

The majority of schemes choose exposure to companies with Science Based Targets as their transition alignment metric.

Off the back of this reporting, we've seen an increase in the % of schemes setting targets on transition alignment (although the most popular aspect for setting targets is on carbon emissions). This is encouraging and we are supportive of more schemes focusing on forward-looking alignment and contribution to the climate transition, not just backward-looking carbon emissions metrics and/or data quality.

Targets set by schemes



Source: XPS review of sample of publicly available TCFD reports

87% of Wave 1 and 84% of Wave 2 reported that they had been successful against the targets which they set last year. We do recognise progress against targets has the potential to be quite volatile as data coverage increases, so schemes should take time to understand sources of underperformance, and what can be done to address this.

Implied Temperature Rise suggests significant portion of assets at risk

The weighted average Implied Temperature Rise (ITR) of the schemes was 2.4°C (2023: 2.8°C), with a range 1.7°C to 3.2°C (2023: 2°C - 3.3°C). This has been calculated by taking into account the proportion of assets where ITR was available within the respective schemes and calculating a weighted average across schemes. This analysis covers 17 schemes who reported ITR covering an average 46% of their assets, totalling £33bn of assets.

Climate Action Tracker suggests that policies currently in place around the world are projected to result in about 2.7°C of warming, and that if binding long-term targets are included and delivered, warming would be limited to 2.1°C. This implies that based on the reported ITR, schemes are on average better placed than the 2.7°C degrees projected for the world, but are lagging policy targets and are not doing enough to support the required outcome of 2°C. Any holdings with an ITR higher than 2.7°C should be considered misaligned to the current pace of the climate transition and should give significant cause for concern.

Conclusion

Overall, we've observed significant progress in setting and enhancing Net Zero targets. The increased alignment with best practice frameworks such as the IIGCC Net Zero Investor Framework and a stronger focus on transition alignment are positive developments.

However, the reported average Implied Temperature Rise of 2.4°C highlights the ongoing risks associated with holding assets not aligned with climate transition goals. Pension schemes, with their long-term investment horizons, are uniquely positioned to support and benefit from the transition to a lower carbon economy, and trustees should take time to fully understand the risks and opportunities they are exposed to.

Actions for trustees

1. **Ongoing training:** Refresh your understanding of latest developments and best practice around climate change and Net Zero.
2. **Take a forward-looking perspective:** Speak to your consultant about defining or enhancing your climate strategy, focus on forward looking transition alignment and consider the growing opportunities to invest in low carbon solutions to support your financial goals.
3. **Engage with your managers:** Track your progress against your targets and review your highest risk holdings. Challenge your managers over what is being done to address those risk aspects. Be prepared for the volatility in your progression that may arise as data coverage increases, particularly within private assets.
4. **Expand approach to scenario analysis:** When updating scenario analysis, consider whether it may be beneficial to use qualitative analysis alongside quantitative to ensure short-term and long-term risk aspects are considered.

Find out more

If you'd like to speak to us about how we can help your scheme meet the TCFD reporting requirements or assess the climate risk exposure of your scheme even if you're not yet subject to the TCFD requirements, please get in touch with Alex Quant or Serena Moore, or speak to your usual XPS contact.

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