# *The Baptist Pension Scheme and climate change –*

## *how we manage climate-related risks and opportunities to the Scheme*

**A report for members**

**by the Trustee of the Baptist Pension Scheme**

**for the Scheme year ending 31 December 2021**

## *Why have we written this report?*

The UK has become the first G20 country to make it mandatory for Britain's largest companies and financial organisations to disclose their climate-related risks and opportunities.

This is part of the government's commitment to making the UK financial system the greenest in the world.

As part of the Baptist Family we have long held the view that investments should be made ethically and our Ethical Policy includes environmental and climate-change issues. So we welcome this initiative and the additional focus it has brought in this area.

This report provides members with the opportunity to find out more about the work carried out by the Trustee in relation to climate change.

It is the first climate change report by the Trustee of the Baptist Pension Scheme. We hope you find it informative and would welcome any feedback.

Chris Maggs

Moderator for Baptist Pension Trust Limited

## *Overview*

*The Trustee of the Baptist Pension Scheme views climate change as a risk to society, the economy and the financial system, but also recognises that reducing carbon emissions throughout the economy presents opportunities.*

*These risks and opportunities may impact the Scheme's financial position, for example by impacting the businesses the Scheme invests in. The Trustee monitors this potential impact and takes steps to reduce climate-related risks for members.*

*This report describes how the Trustee has identified, assessed and managed climate-related risks and opportunities to the Scheme during the Scheme year to 31 December 2021.*

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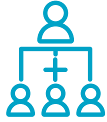
Published alongside the Scheme's annual report and accounts for the Scheme year to 31 December 2021 and available online **here**.

# *Key findings*

1. **Governance – the Trustee has a robust framework for managing the Scheme, including setting clear expectations and responsibilities in relation to climate change.**

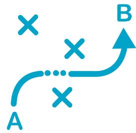


A Climate Governance Statement defines responsibilities of everyone involved

Climate-related risks and opportunities are reviewed regularly at Investment Committee meetings in light of the Trustee's ethical policy

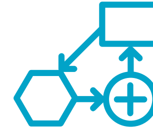
The Scheme's advisers support the Trustee on climate-related matters

2. **Strategy and Risk Management – the Trustee has taken steps to understand how climate change might affect the Scheme and to control the risks it has identified. Based on the analysis carried out, the Trustee expects climate change to potentially impact the Scheme more significantly over the longer term. It aims to reduce the risks to the Scheme in several ways:**

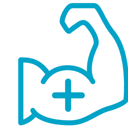



Significantly reducing the DB section's exposure to riskier assets, where possible

Investing responsibly, in line with the Trustee's Ethical Investment Policy



Regularly reviewing the Scheme's investment managers' climate practices



Using the Scheme's influence as an investor to encourage climate action

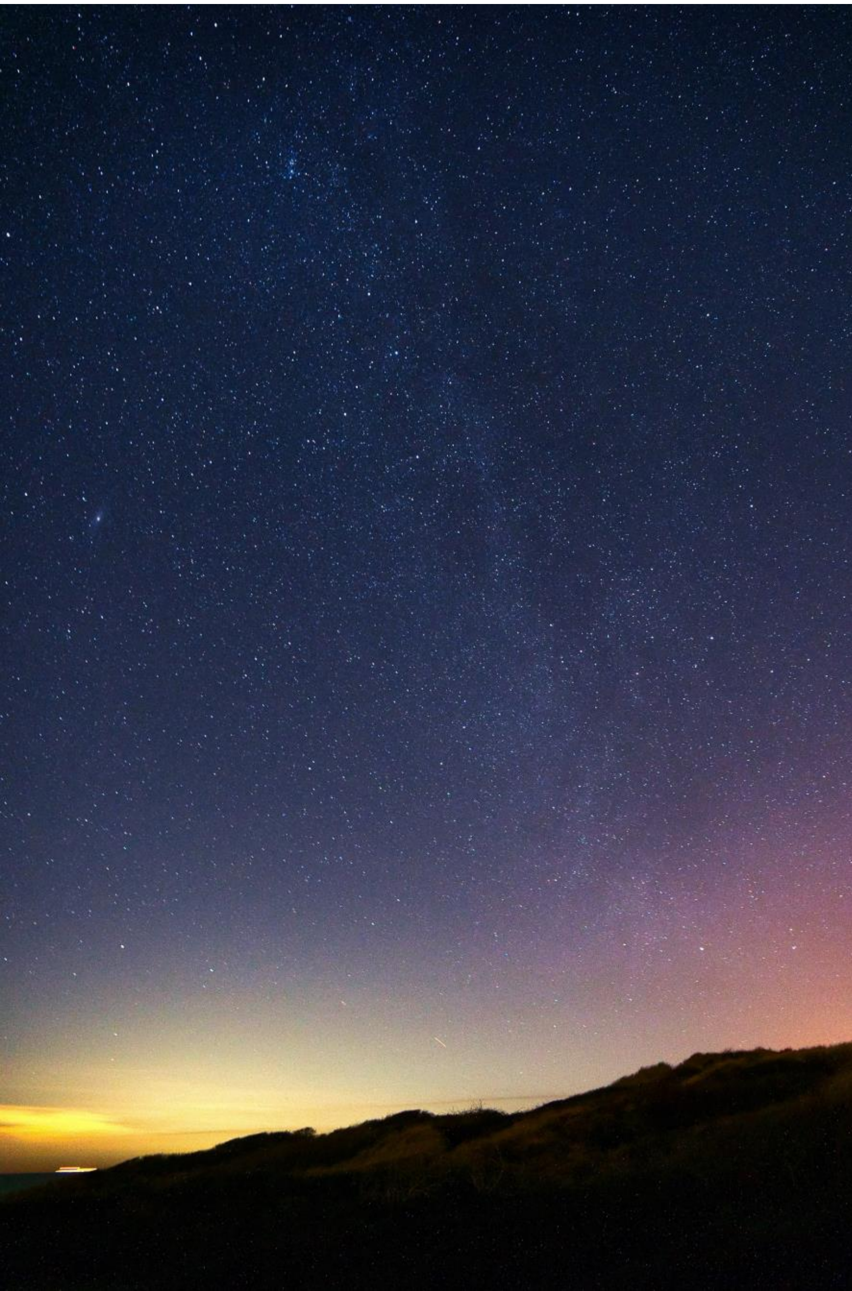
3. **Metrics and Target – the Trustee has collected and reviewed information about the greenhouse gas emissions, carbon footprint and emissions reductions targets for the assets the Scheme invests in, to help it understand the Scheme's exposure to climate risks. It has set a target to increase the proportion of companies it invests in with science-based emissions reductions targets.**

Collected and reviewed greenhouse gas emissions data for the Scheme's investments

Reported proportion of investments with no data or estimated data

Target for 80% of investee companies to have emissions reduction targets by 2030

# Detailed report

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# *Section 1 - Introduction*

### *About the Baptist Pension Scheme (the 'Scheme')*

The Scheme is a multi-employer scheme, with members and sponsors from over 1,000 individual churches and other Baptist organisations around the UK. Broadly speaking, each sponsor is responsible for their own current and former employees in each section within the wider Scheme.

The Scheme has a Defined Benefit ("DB") section (with invested assets of c£187m in December 2021, plus an insurance policy valued at c.£150m which pays the benefits of many retired members) and a Defined Contribution ("DC") section (with assets of c£67m in December 2021). The DC section has one investment strategy members are automatically enrolled in ("default strategy"), unless they actively choose one of the alternative funds available. The majority of DC members (c86%) are invested in the default strategy.

### *The purpose and structure of this report*

The purpose of this report is to describe the Scheme's governance framework for managing climate-related risks and opportunities and how it has been implemented in the year to 31 December 2021. It is the Scheme's first report in line with the recommendations of the Taskforce on Climate-Related Financial Disclosures (TCFD), as required by the 2021 Climate Change Governance and Reporting Regulations.

This report covers the TCFD's thematic areas of:

- **Governance** - the Scheme's governance around climate-related risks and opportunities;
- **Strategy** – the potential impacts of climate-related risks and opportunities on the Scheme and the resilience of the Scheme's investment strategy and DB funding strategy under different climate-related **scenarios**;
- **Risk Management** – the processes used by the Scheme to identify, assess, and manage climate-related risks;
- **Metrics and Targets** – the metrics and target used to assess and manage relevant climate-related risks and opportunities to the Scheme.

Governance is covered in Section 2 of the report; Strategy and Risk Management are covered in Section 3, with details of the climate scenario analysis in Appendix 1; and Metrics and Targets are covered in Section 4. There is a Glossary in Appendix 3 and the other appendices provide more detailed information on various topics.

## *How the Trustee maintains oversight of climate-related risks and opportunities relevant to the Scheme*

### Establishing responsibilities

In September 2021, the Trustee agreed a full Climate Governance Statement (also known as "Roles and Responsibilities" document) which clearly lays out the division of responsibilities between the Trustee, Investment Committee, Actuarial Consultant and Investment Consultant in order to maintain appropriate oversight of the climate-related risks and opportunities relevant to the Scheme and so that the Trustee can be confident that its statutory and fiduciary obligations are being met.

### The role of the Trustee

The Trustee of the Scheme has ultimate responsibility for ensuring effective governance of climate change risks and opportunities in relation to the Scheme. This is done by the Trustee Board and Investment Committee, with support from the Pensions Manager and the Trustee's external consultants.

As the Trustee has ultimate responsibility for scheme governance activities, its role is to review and discuss any information, decisions and proposals that have been made by the Investment Committee, the Governance and Risk Committee and/or its advisers. Having done so, the Trustee Directors will then confirm or amend any decisions or proposals made, and ensure the decisions are implemented appropriately. All decisions are ratified by the Trustee Board, including but not limited to decisions relating to climate change.

The Trustee role also includes:

- Agreeing training requirements and scheduling them into the business plan;
- Ensuring the climate governance arrangements remain appropriate and effective;
- Signing off the Trustee's investment beliefs, investment policies and risk registers, including appropriate climate-related wording;
- Ensuring any advice from the actuarial consultants is requested and carried out appropriately;
- Communicating with Scheme members and other stakeholders on climate change where appropriate.

### The role of the Investment Committee

The Investment Committee provides the Trustee with regular updates and guidance following the reviews it has carried out and sets out any decisions that are required. It does this by:

- Reviewing and discussing all investment advice received, including ensuring appropriate consideration of climate change;
- Reporting back significant pieces of investment advice and recommendations to the Trustee, including any advice and recommendations relating to climate change;
- Ensuring any advice from the investment consultants is requested and carried out appropriately;
- Providing recommendations in respect of the investment consultants' competency;
- Meeting with the investment managers regularly and receiving updates on the managers' approaches to climate risk and opportunities;
- Reviewing the metrics and targets to assess climate-related risks and opportunities in relation to the Scheme's investment managers.

### The role of the Pensions Manager

The Pensions Manager's role is to ensure that the Trustee Board, Investment Committee and its advisers have full access to all the information needed on the Scheme and to help implement any decisions made. The Pensions Manager attends the Trustee's climate-related training sessions and other opportunities for similar training from investment specialists in the pensions industry.

## *Oversight activity*

### Oversight activity - at the regular Board meeting

At its regular Board meeting each quarter, the Trustee receives and reviews:

- An update from the Governance and Risk Committee which includes any recent review of the Scheme's DB and DC risk registers. Where appropriate this includes updates in relation to the climate-related risks and opportunities identified in the risk registers.
- An update from the Investment Committee on the Scheme's investments. Where appropriate these include updates in relation to the investment managers' climate policies, and their assessment of relevant climate-related risks and opportunities.

### Oversight activity – by the Investment Committee

The Investment Committee considers climate-related risks and opportunities within each investment topic and individual mandates as and when they arise at quarterly meetings. The Investment Committee also reviews (at least annually):

- A responsible investment report from the Scheme's investment consultant that reviews the Scheme's investment managers in relation to environmental, social and governance (ESG) factors and climate change;
- Data on climate-related metrics and progress against the target set in relation to these metrics (see page 28);
- Whether it is appropriate to carry out scenario analysis that illustrates how the Scheme's assets and liabilities might be affected under various climate change scenarios;
- Their consultants' climate competency including assessing how they have performed against their climate responsibilities.

### Oversight activity – other regular items

The Trustee also considers climate-related risks and opportunities whenever the following activities are undertaken:

- Actuarial valuation of the Scheme's DB section;
- Review of the investment strategy for the Scheme's DB and DC sections;
- Assessment of the sponsoring employers' covenant.

### Oversight activity – appointments

Whenever it reviews its agreements with external consultants, or appoints new consultants, the Trustee also considers and documents the extent to which the consultants' climate-related responsibilities are included in the agreements and/or any consultant objectives set. In particular, the following objectives have been set for the investment consultant that are relevant to climate considerations:

- Take into account the Scheme's ethical policy, ESG and stewardship considerations in advising on the implementation of the Scheme's investment strategy;
- Help the Trustee understand climate risks within each investment mandate vs the Trustee's investment beliefs;
- Inform the Trustee of regulatory changes and assist the Scheme in becoming compliant; and
- Help the Trustee establish processes and procedures in relation to climate change.

# Section 2 – Governance – oversight of climate-related risks and opportunities

## *Oversight activity*

**Oversight activity – annual business plan**

When setting its annual business plan, the Trustee ensures appropriate coverage of ESG and climate-related topics. In addition, the Trustee directors assess their knowledge and understanding of climate risks and opportunities and identify any training requirements needed to ensure they have the skills required to manage these risks and opportunities.

Climate-related training sessions typically include an annual update on recent developments, with interim training on any time-critical developments. They may also include training in support of specific agenda items at Trustee meetings. The training undertaken is documented in the Trustee's training log.

**Activities undertaken**

During 2021, the Trustee and Investment Committee allocated significant additional meeting time to climate-related topics and commissioned additional advice in order to deepen its understanding of climate change, enhance the Scheme's management of climate-related risks and opportunities, and satisfy its regulatory obligations. The box on the right shows the agenda items discussed by the Investment Committee with other Trustee Board Directors also attending at times.

**Determining the correct apportionment of resources**

The key rationale for allocating resources to this area is that the Trustee believes that environmental, social and governance (ESG) factors are likely to be one area of market inefficiency and so managers may be able to improve risk-adjusted returns by taking account of ESG factors which include factors relating to climate change.

**Investment Committee climate-related agenda items in 2021**

- Feb 2021 – Training on new TCFD-related requirements
- May 2021 - Update on climate change governance and reporting regulations
- June 2021 – Potential credit managers' climate approaches
- August 2021 – Update on regulatory environment, scenario modelling
- Sept 2021 - Responsible investment review, Climate dashboards for TCFD reporting, Review of risk register for climate risks, Roles and responsibilities document for managing climate risks and opportunities
- Nov 2021 - Climate dashboards for TCFD reporting, Metrics and Target for TCFD reporting

# *Section 2 – Governance – oversight of climate-related risks and opportunities*

## *How the Trustee incorporates climate-related risks into its Statement of Investment Principles and Ethical Investment Policy*

The Trustee incorporates its beliefs and policies on climate-related risks into its Statement of Investment Principles and Ethical Investment Policy, which help to define the investment strategy for the Scheme.

**Climate beliefs within the Statement of Investment Principles**

…for both DB section and DC Plan, … environmental, social and governance (ESG) factors are likely to be one area of market inefficiency and so managers may be able to improve risk-adjusted returns by taking account of ESG factors including factors relating to climate change.

**Climate-related policies within the Ethical Investment Policy**

Positive Screening - This means investing in companies or sectors which reflect Christian values in areas like… environmental protection, supporting sustainable development…

Negative Screening - This means avoiding investment in companies or sectors or companies undertaking a particular activity or operating in a way which may be harmful and inconsistent with our Christian values and ethos. The Trustee will therefore avoid investment in companies with significant trading in… the extraction of coal and tar sands, other fossil fuels extraction unless a company is considered to be moving significantly to sustainable energy policies… Significant trading or involvement is normally taken to mean greater than 10% of turnover.

The Trustee amended its Ethical Policy on 9 December 2021 to include negative screening for significant trading in all extraction, production and refining of fossil fuels (see Section 3).

# *Section 2 – Governance – oversight of climate-related risks and opportunities*

## *The processes the Trustee has established to satisfy itself that adequate steps are being taken and that third parties are taking adequate steps to identify, assess and manage those risks and opportunities*

The Trustee seeks input from its investment, actuarial and covenant advisers to ensure that it is able to identify, assess and manage climate risks and opportunities. From time to time, the Trustee will review the climate competency of its advisers and take appropriate action if any concerns are identified. In September 2021, the Trustee reviewed its investment consultants against the agreed strategic objectives and concluded that the investment consultants have demonstrated value added as expected over the period considered, including through consideration of climate change where appropriate. When appointing new advisers in future, the Trustee would consider whether the advisers have suitable climate credentials.

With appropriate advisers in place, the Trustee ensures that climate-related risks and opportunities are considered as part of any relevant advice, such as the actuarial valuation process, investment strategy review and assessment of the sponsoring employer's covenant, with climate change included in the agenda items for each of these at the relevant meetings.

The Trustee also ensures that the Investments and Governance and Risk Committees have suitable experience in considering climate risk, to ensure that the risks are suitably considered, documented, reviewed and kept up to date.

The Trustee and the Investment Committee satisfy themselves that their consultants take adequate steps to identify and assess climate-related risks and opportunities which are relevant to the matters on which they are advising by ensuring the consultants:

- Are set clearly defined responsibilities in respect of climate change;
- Have documented their responsibilities in relevant agreements, such as investment consultants' strategic objectives and service agreements;
- Have adequate expertise and resources, including time and staff, to carry these out;
- Are adequately prioritising climate-related risk.

# Section 3 – Strategy and Risk Management

## *Introduction*

The Trustee has implemented a number of processes and tools for identifying, assessing and managing climate-related risks and opportunities, including climate scenario analysis, an ethical investment policy, monitoring of metrics and targets and stewardship, as well as ensuring its advisers have processes in place to help it research its investment managers' climate-related practices.

These tools have helped the Trustee consider issues such as:

- Which climate change risks are most material to the Scheme;
- How to take account of transition and physical risks; and
- How climate change affects the Trustee's risk appetite.

The tools are used to identify the key risks that the Trustee should focus on. The Trustee then ensures that these risks are fed into its investment decision processes for both the DB and DC sections as well as feeding into the covenant and DB funding processes. It also feeds into the Trustee's risk registers to ensure all risks are being monitored and managed consistently and proportionately.

The Trustee has used the climate scenario analysis as a key tool for identifying, assessing and managing climate-related risks and opportunities. In particular, it has used the analysis to identify the time horizons over which the physical risks and transition risks could materialise. It has then considered what the possible impacts of climate change could be over each of these time horizons and whether its current DB funding and investment strategies are likely to be robust against these risks (or able to take advantage of any opportunities).

Climate scenario analysis was carried out for the Scheme's DB and DC sections in August 2021 (see Appendix 1). The Trustee will carry out scenario analysis at least every three years and check annually if the review should be carried out sooner.

The results of the analysis are fed into the integrated risk management of the DB section through specific covenant, investment and DB funding focused considerations and the interaction of these.

The results for the DC section will feed into the Trustee discussions and decisions on the default investment option and how members could be impacted at different ages over different time periods.

## *Identification and assessment of climate-related risks and opportunities relevant to the Scheme*

For the purpose of identifying and assessing climate-related risks and opportunities, the Trustee has defined the following time horizons for each section of the Scheme:

| | Defined Benefit section | Defined Contribution section |
|---|---|---|
| **Short-term** | **Up to 5 years** – Current de-risking time frame to reach low risk funding target. Currently expecting contributions into the DB section to reach this target in this time frame | **Up to 5 years** - Major improvements in climate data quality are expected over this period |
| **Medium- term** | **5 to 10 years** – Likely period over which insuring the Scheme is targeted (if not in the short term). Will depend on insurance pricing and development of funding position over time | **5 to 10 years** – Key period over which policy action will determine if Paris Agreement goals can be met |
| **Long-term** | **10 to 30 years** – If the DB section is run on this long, the climate related impacts are expected to increase significantly | **10 to 30 years** – Many developed economies are targeting to be net zero by this point |

These time horizons have informed the Trustee’s climate-related considerations and decisions during the year.

## *Overview of the climate-related risks and opportunities relevant to the Scheme that the Trustee has identified*

The Trustee has identified and assessed the risks and opportunities to the Scheme within each of these time horizons, as summarised below.

These risks and opportunities are considered further in the following sections where we discuss further the Trustee approach to investment, covenant and DB funding risks and opportunities.

### *For the DB section*

| | *Key risks* | *Key opportunities* |
|---|---|---|
| *Short term* | Exposure to climate-related investment risks may be highest while you retain an allocation to growth assets | Climate-tilted equity funds aim to protect against transition risks and provide exposure to transition opportunities |
| *Medium term* | Market volatility could cause investment losses and increase time to reach full funding on buy-out basis | Climate-aware credit mandates should increase the resilience of assets to climate risks |
| *Long term* | Cost of buy-out may increase as insurers allow for climate-related risks in their pricing and reserving bases | Buy-out is expected to provide greater protection from climate risks for members' benefits and there may be pricing opportunities along the journey |

### *For the DC section*

| | *Key risks* | *Key opportunities* |
|---|---|---|
| *Short term* | Older members within 10 years of retirement will be most exposed to transition risks in the short term in the event of a Paris disorderly pathway | Low carbon investments can mitigate the impact of market shocks due to a market repricing event |
| *Medium term* | Transition risks may still be heightened over the medium term creating volatility. Market returns may be lower if disorderly transition harms economic performance | Impact investments can take advantage of the shift to a low carbon economy and may provide an enhanced source of return over this period |
| *Long term* | Physical risks are most prevalent in the failed transition pathway, impacting those members 20 years or more from retirement | Engagement with investment managers to ensure they are exercising stewardship in support of net zero pathways is key to avoiding a failed transition |

## *Investment risk – overview*

The Trustee considers climate risk as part of discussions on further de-risking of the DB section's investment strategy. Climate risk is one further reason as to why equities / growth assets could potentially detrimentally impact the Scheme's DB funding position over the years ahead, and the Trustee analysis has re-affirmed the need to have a clear plan to de-risk.

The Trustee is annually monitoring the Scheme's exposure to climate-related risks in each individual investment fund and considering ways to limit its exposure. This risk limitation is currently implemented through its risk management processes detailed throughout this report.

The Trustee is also actively targeting insuring the whole of the DB section with an insurance company which will ultimately transfer the majority of the remaining climate risks to the insurer. Climate change may impact the cost of insurance. Therefore, the Trustee will need to monitor insurance pricing until the point of transaction to ensure that insurer pricing remains appropriate for the Scheme taking into account all of the current risks including climate risk.

The DB section is not yet in a position where it can transfer all remaining risks to an insurer, therefore the Trustee continues to monitor the DB funding position and level of investment risk on a regular basis, and climate risks and opportunities are incorporated into those discussions.

In particular, during 2021, the Trustee and Investment Committee has considered each of its investment managers' approaches to climate risk, as part of its responsible investment review for 2021. A summary of the process followed and findings is provided on pages 17-18.

The Investment Committee also meets with investment managers at each of its quarterly meetings and these meetings include a review of managers' ESG activities (including climate change) and how that aligns with the Trustee's expectations.

The Investment Committee continues to monitor climate-related investment opportunities that arise, that would fit its investment criteria as well as those that fit with the DB section's journey plan to a fully de-risked investment strategy by the end of 2028.

## *Ethical Investment Policy and approach to stewardship*

**Ethical Investment Policy – DB section**

The Trustee has an Ethical Investment Policy which applies to the non-defined contribution assets of the Scheme. The Investment Committee is also responsible for monitoring how well the Scheme's investment managers are aligning to this policy. The purpose of the policy is to encourage companies to act responsibly in the interests of their shareholders, employees and other stakeholders.

The policy specifically addresses climate risks by excluding fossil fuel extraction companies, unless a company is deemed to be moving significantly to sustainable energy policies. The Trustee amended its Ethical Policy on 9 December 2021 to include negative screening for significant trading in all extraction, production and refining of fossil fuels.

The policy specifically addresses climate opportunities by positively allocating to companies involved in environmental protection and supporting sustainable development.

As stated in the policy, the Trustee regards itself as "stewards of the world" and will avoid investment in companies that act without proper regard to the environment.

**Ethical Investment Approach – DC section**

The Ethical Investment Policy does not apply to the DC section of the Scheme due to the Scheme investing in pooled funds. However, the Trustee, with help from its Investment Committee and advisers, has sought to align the DC investment funds with its ethical and climate beliefs, where possible.

In particular, the global equity component of the DC default strategy (c45% of DC assets) addresses climate risks by only investing in companies with good ESG practices, including climate-related practices. It excludes companies whose main business is coal mining and some companies which do not meet minimum standards for climate management quality.

The DC section also offers the BMO Responsible Global Equity Fund, which excludes fossil fuels and positively allocates to resource efficiency and the energy transition.

**Stewardship**

The Trustee uses stewardship to help manage climate-related risks. Voting and engagement activities are delegated to the individual investment managers. Each manager has its own ESG policy, which includes assessment of climate-related risks and policies on voting on climate-related resolutions.

In order to monitor how the individual investment managers are exercising their voting rights and undertaking engagement on behalf of the Trustee, the Investment Committee:

- periodically meets with the Scheme's investment managers, to engage with them on how they have considered ESG issues (including climate change) within their stewardship activities and will seek to challenge the investment managers on these matters where they think this is in the best interests of members; and

- further monitors the investment managers by receiving stewardship and governance reports from the investment managers on a quarterly basis.

## *Investment risk and annual Responsible Investment Review*

### Investment monitoring

The Scheme's investment advisers provide quarterly investment performance monitoring reports in respect of the two sections. Any concerns in relation to the investment managers are being monitored as part of this process.

The Investment Committee is responsible for carrying out an annual responsible investment review (see opposite).

The Investment Committee also receives and reviews detailed climate monitoring (including the three chosen climate metrics) from its investment adviser and investment managers, on an annual basis. The first calculations and reporting of these metrics, along with other climate risk exposures, were discussed at the September and November 2021 meetings. The reporting included a comparison of the climate characteristics of each fund with the climate characteristics of a suitable index.

### Annual Responsible Investment Review - Process

The investment managers are asked to disclose whether the funds they manage on behalf of the Scheme are in compliance with the Scheme's Ethical Investment Policy (the latest iteration of this policy was dated September 2019 at the time when the 2021 annual responsible investment review was carried out). If there are any holdings in breach of the Policy, the investment managers must disclose the name of the holding, the industry and the allocation of the overall portfolio to this holding.

If applicable, the managers provide a list of the negative and positive screening criteria they use. In addition, in 2021, the investment managers were asked for the exposure, if any, to fossil fuel extraction within the funds they manage on behalf of the Scheme.

The review includes a summary of the investment managers' climate approaches, the investment adviser's view on the extent to which climate considerations can be applied within each asset class and whether any action is required. In relation to the DB section, consideration was given to whether fund allocations are expected to decrease in size as the Scheme matures and the level of risk within the investment strategy is consequently reduced.

The Scheme's investment consultants produced a report for the Investment Committee in September 2021 to provide their view of the investment managers' responses and advise on any recommended changes.

## *2021 Responsible Investment Review - Findings*

The Investment Committee was comfortable with the level of alignment between the investment managers' portfolios and the Ethical Investment Policy. There had been no material changes since the previous year.

Overall, the investment managers were believed to be broadly in line with their peers in terms of managing ESG and climate risks.

The report identified the funds for which climate-related risks are an important part of the investment process. These funds have lower carbon exposure compared to the average fund with similar characteristics. In particular, one active equity fund and two bond funds were identified as having strong climate policies (which was to be expect given ESG factors, including climate risk, are an important part of the Trustee's manager selection process). These two bond funds are expected to form an increasingly important part of the DB section's investment strategy as it reduces its investment in growth assets over its de-risking journey (which it aims to complete by the end of 2028).

Some of the funds have an ethical focus which include policies that reduce the exposure to climate-related risks. The review noted that other funds are available, such as low carbon equity funds, that have lower carbon exposure than these ethical funds. However, these alternative funds were less well aligned with other parts of the Trustee's Ethical Investment Policy.  This compromise, along with the potential transaction costs to change and - in the case of the DB section's equity holdings - the relatively short investment time horizon, meant the Investment Committee did not believe lower carbon funds were appropriate at this time.

The DB section invests in a segregated multi-asset mandate with relatively high exposure to carbon intensive companies. The review concluded by adding a climate-related restriction to the investment management agreement for this mandate, and the holdings in breach of the new restriction were subsequently sold.

All other DB section mandates are pooled, hence the Investment Committee is not able to add climate-related restrictions to those investment management agreements.  However, the report concluded that most have relatively little fossil fuel exposure but noted that this is not guaranteed to continue going forward.

The Investment Committee considered if fossil fuel companies should be added to the exclusion list in the Scheme's Ethical Investment Policy.  This was subsequently agreed and is being implemented in 2022 (ie it is being added to the investment restrictions for the segregated mandate and the level of alignment will be monitored annually for the pooled mandates).

## *Covenant risk and monitoring and DB funding risk*

**Covenant risk and monitoring**

At its meeting in August 2021 as part of the climate scenario analysis, the Trustee discussed the sponsoring employers' covenant and how this might interact with the Scheme under different climate scenarios.

The Trustee understands that one of the main strengths of the covenant is through the buildings owned by each of the employers. Many of these are energy-inefficient and so may be hit by increased energy costs, any taxes on inefficient buildings, or costs to upgrade in the future. Clearly this may make it harder for the covenant to fund the DB section's contributions under some climate scenarios. However, the current DB contribution requirements are expected to be met over the shorter term of the Scheme, and therefore this risk was considered to be manageable at the current time. It will continue to be monitored through regular covenant reviews and discussions with the sponsoring employers.

Whilst there are often restrictions on changes to some of the buildings (as they are listed), the Baptist Union considers both physical and transition climate risks and the impact on the buildings when providing finances for improvements to the buildings.

When assessing the employers' covenant as part of its regular covenant assessments (including the detailed assessment for each triennial valuation), the Trustee will ensure that climate risk has a specific focus. This will enable the Trustee to determine whether the sponsoring employers' risks relating to climate change could impact the level of support available, especially when this support is most needed.

**DB funding risk**

The Trustee has considered the DB funding strategy of the Scheme in light of the scenario analysis and discussions around covenant and investment.

In particular, the current DB funding strategy is considered to be somewhat resilient to climate change as it is targeting a more de-risked position over a fairly short period of time (by 2028), with insurance of all members' DB benefits with an insurer anticipated over the medium term (by 2030). The DB funding position will still be susceptible to climate change pricing-in shocks over the short term. If the Scheme is negatively impacted by such market shocks, the journey to full insurance over the medium term may be affected and mean that medium term risks will need further consideration.

The Trustee will continue to monitor progress towards this more de-risked position to ensure that climate risks (and other risks) continue to be managed and where possible mitigated along the journey. This monitoring is carried out through regular DB funding updates and investment performance reviews, together with any ad hoc updates from the Trustee's actuarial and investment advisers.

The Trustee has considered the impact of climate change on mortality, noting that there is a significant level of uncertainty on the impact of climate change. There are both positive and negative factors that could impact the Scheme under the scenarios considered. The Trustee agreed to ensure that mortality is considered in the context of climate risks as part of the next Actuarial Valuation when more information may be available on the potential impacts.

## *Risk registers*

**Trustee's risk registers**

The Trustee maintains two risk registers covering the wide range of risks run in the DB and DC sections respectively. The Governance and Risk Committee maintains and updates the risk registers, with any amendments notified to the Trustee Board.

The Trustee updated both registers during 2021 to include a number of specific climate risks to ensure that the Trustee manages these as part of its regular risk reviews. Climate risk areas included in the risk registers include:

- Knowledge and understanding of climate risks
- Compliance with climate risk legislation
- Regular review of climate risks relevant to the DB and DC investment strategies
- Covenant and DB underfunding risk due to climate risks
- Reputational risks of not tackling climate risk appropriately
- Inadequate communication with members on climate risk.

These are reviewed regularly to consider if any further risks need adding or amending, to assess any significant priority risks to manage and to ensure regular action is maintained in monitoring and mitigating these risks.

The Trustee's current assessment, based on consideration of their impact and likelihood, is that climate-related risks are fairly low risk for the Scheme and therefore should continue to be monitored in accordance with the current monitoring processes.

# Section 4 – Metrics and Targets

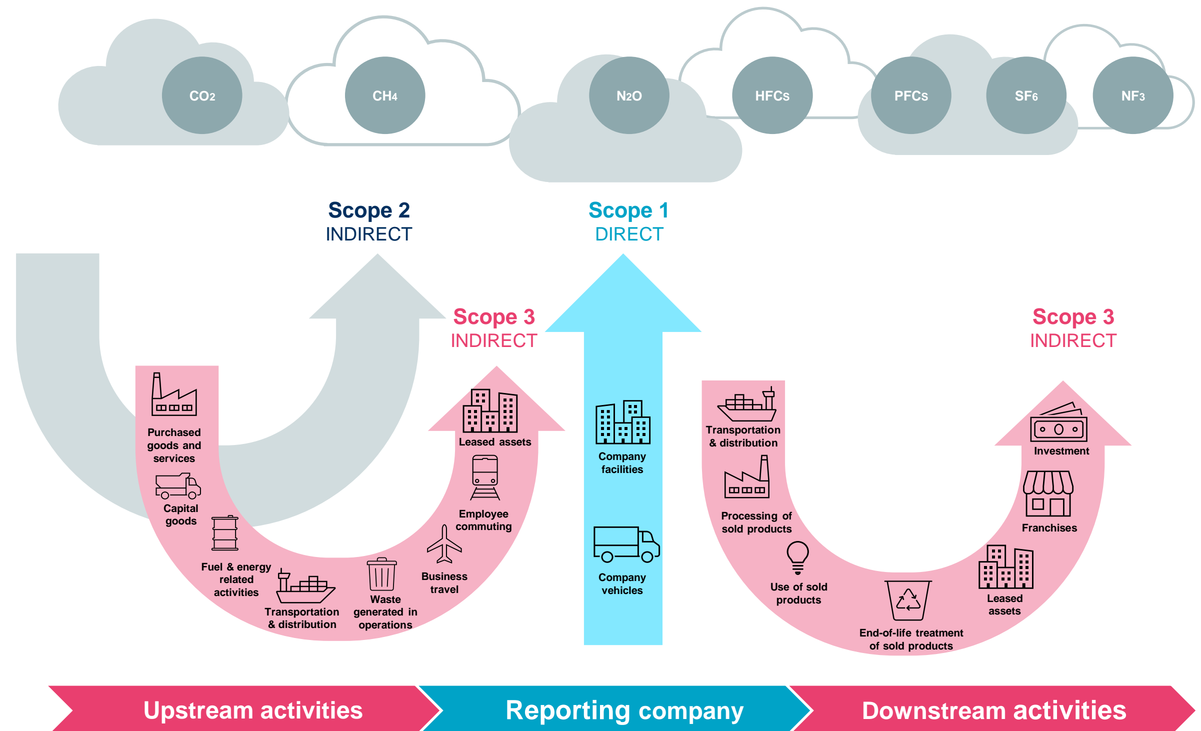
*This section provides further detail about the metrics and target used to assess and manage relevant climate-related risks and opportunities to the Scheme.*

**Greenhouse gas emissions explained**

Within the 'metrics and targets' section of the report, the emissions metrics relate to seven greenhouse gases – carbon dioxide ($CO_2$), methane ($CH_4$), nitrous oxide ($N_2O$), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), sulphur hexafluoride ($SF_6$) and nitrogen trifluoride ($NF_3$). The figures are shown as "$CO_2$ equivalent" ($CO_2e$) which is the amount of carbon dioxide that would be equivalent to the excess energy being stored by, and heating, the earth due to the presence in the atmosphere of these seven greenhouse gases.

The metrics related to greenhouse gas emissions are split into the following three categories: Scope 1, 2 and 3. These categories describe how directly the emissions are related to an entity's operations, with Scope 1 emissions being most directly related to an entity's everyday activities and Scope 3 referring to indirect emissions linked to an entity's activities. Scope 3 emissions often form the largest share of an entity's total emissions, but are also the ones that the entity has least control over.

- **Scope 1** greenhouse gas emissions are all direct emissions from the activities of an entity or activities under its control.
- **Scope 2** greenhouse gas emissions are indirect emissions from electricity purchased and used by an entity which are created during the production of energy which the entity uses.
- **Scope 3** greenhouse gas emissions are all indirect emissions from activities of the entity, other than scope 2 emissions, which occur from sources that the entity does not directly control.




Source: GHG Protocol

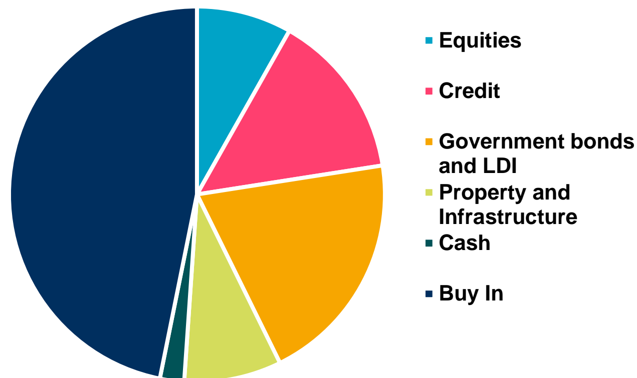
## Metrics – DB section

The Trustee has chosen three climate-related metrics to help it monitor climate-related risks to the Scheme. These are listed below and reported overleaf for the DB section (as far as the Trustee was able to obtain the data).

| Metric | High-level methodology[1] |
|---|---|
| **Absolute emissions: Total greenhouse gas emissions** | The sum of each company's most recent reported or estimated greenhouse gas emissions attributable to the Scheme's investment in the company, where data is available. Emissions are attributed evenly across equity and debt investors. Reported in tonnes of $CO_2$ equivalent. This methodology was chosen because it is in line with the statutory guidance. |
| **Emissions intensity: Carbon footprint** | The total greenhouse gas emissions described above, divided by the value of the invested portfolio in £m, adjusted for data availability. Emissions are attributed evenly across equity and debt investors. Reported in tonnes of $CO_2$ equivalent per £1m invested. This methodology was chosen because it is in line with the statutory guidance. |
| **Portfolio alignment: Emissions reduction targets** | The proportion of the portfolio by weight of companies that have a carbon emissions reduction target that has been approved by the Science Based Targets initiative or equivalent. Reported in percentage terms. The Trustee chose this "binary target" measure because it is the simplest and most robust of the various portfolio alignment metrics available. |

The Trustee was unable to obtain data for the LDI mandate and insurance policy in relation to the DB section.

**DB section asset allocation as at 30 September 2021**




**Total DB section coverage of 31%**

| Asset class (% DB assets) | Details of missing data or estimations |
|---|---|
| **Equities (8%)** | See Appendix 2. |
| **Credit (14%)** | |
| **Government bonds and LDI (20%)** | BMO confirmed that at the time of writing it is unable to produce metric information for government bonds and its LDI funds. |
| **Property and Infrastructure (8%)** | The metric information was provided directly by JP Morgan and CBRE. Please note that CBRE was unable to split its emission data into Scope 1, 2 and 3 as a full breakdown is not currently provided through its GRESB reporting. |
| **Cash (2%)** | Metric information provided directly by BMO. |
| **Buy In (47%)** | JUST confirmed that at the time of writing it is unable to produce metric information for the insurer buy-in. |

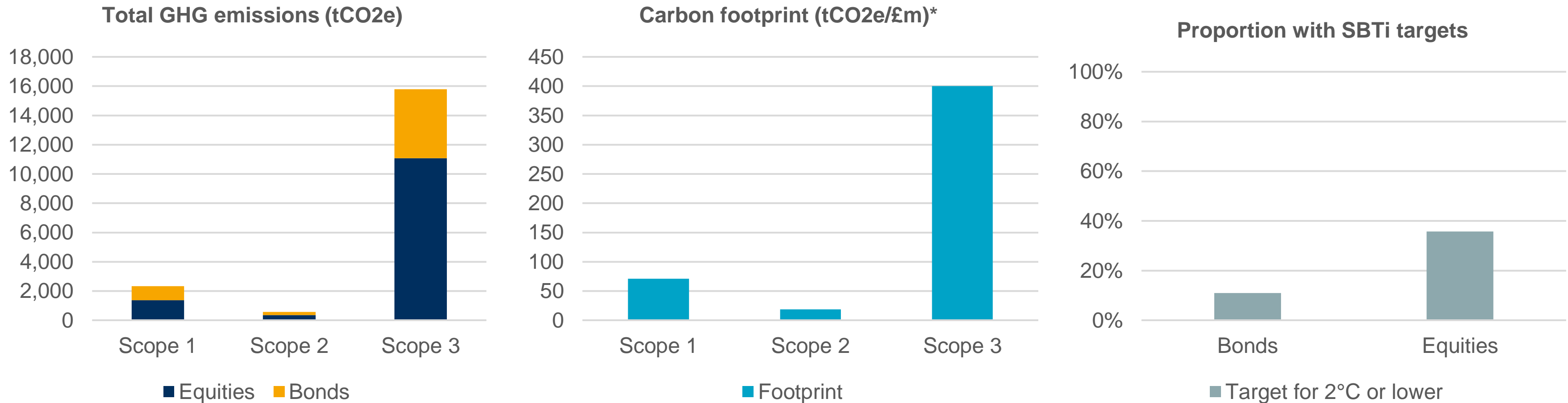
## *Metrics – DB section*

| Manager, asset class and valuation (£m) | | Portfolio value analysed (£m) | Scope 1 and 2 emissions | | | Scope 3 emissions | | | Emissions targets | Data source | Date of portfolio value and holdings |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Total GHG emissions ($tCO_2e$) | Carbon footprint ($tCO_2e$/£m) | Coverage | Total GHG emissions ($tCO_2e$) | Carbon footprint ($tCO_2e$/£m) | Coverage | Proportion with SBTi target (%) | | |
| **Ruffer DGF (Equities)** | 6.1 | 5.8 | 797 | 152 | £5.2m/90% | 6,059 | 1,164 | £5.2m/90% | 12.6 | MSCI | 30/06/21 |
| **LGIM Equities** | 18.5 | 18.3 | 947 | 52 | £18.3m/100% | 4,963 | 273 | £18.3m/100% | 43.1 | MSCI | 30/09/21 |
| **RLAM Bonds** | 24.5 | 24.0 | 712 | 72 | £9.9m/41% | 3,051 | 307 | £9.9m/41% | 11.9 | MSCI | 31/03/21 |
| **Henderson Bonds** | 16.0 | 7.1 | 397 | 156 | £2.5m/36% | 1,224 | 488 | £2.5m/36% | 3.7 | MSCI | 30/06/21 |
| **LGIM FW Bonds** | 4.6 | 4.4 | 66 | 25 | £2.6m/60% | 433 | 165 | £2.6m/60% | 31.4 | MSCI | 30/09/21 |
| **Ruffer DGF (Bonds)** | 6.0 | Not available | - | - | - | - | - | - | - | - | - |
| **Government bonds and LDI** | 56.8 | Not available | - | - | - | - | - | - | - | - | - |
| **CBRE Property*** | 12.8 | 12.8 | 250 | 31 | £8.1m/63% | - | - | - | - | CBRE | 31/12/20 |
| **JP Morgan Infrastructure** | 26.4 | 26.4 | 7,022 | 266 | £26.4m/100% | - | - | - | - | JPM | 31/12/20 |
| **BMO liquidity fund** | 2.7 | 2.7 | 35 | 13 | £2.7m/99.9% | - | - | - | - | BMO | 30/09/21 |
| **Buy In** | 147.7 | Not available | - | - | - | - | - | - | - | - | - |

Source: Investment managers, MSCI, LCP.
Certain data ©2021 MSCI ESG Research LLC. Reported by permission. See Appendix 2 for more details, including how to interpret data where coverage is less than 100%.
*Please note that CBRE was unable to split out its Scope 1, 2 and 3 emissions data. We have instead included its total emissions data.

## *Metrics – DB section*

The charts below summarise the data for the equities and bonds shown on the page before. The next two pages give a breakdown of the data quality for the three metrics.  As the other asset classes were either unable to provide data or split its emissions data into Scope 1, 2 and 3 these have not been included in the charts below.




Source: Investment managers, MSCI, LCP.  *Based on £1m invested in proportion to the Scheme's assets for which data is available.
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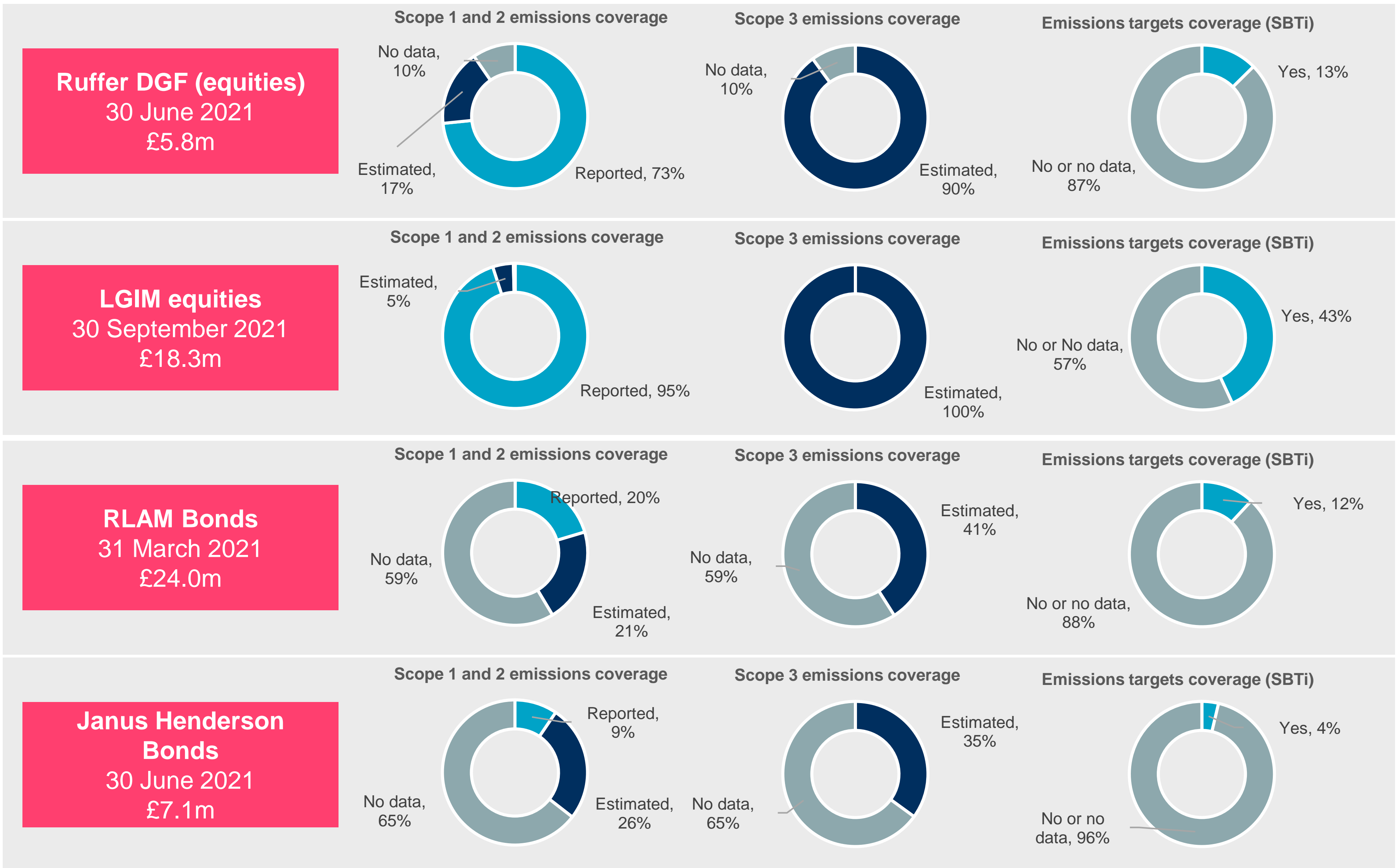
# Section 4 – Metrics and Targets

*Metrics – DB section:* Breakdown of data coverage. This is shown as the split of portfolio value analysed (not the split of the emissions figures).




Source: Investment managers, MSCI, LCP.
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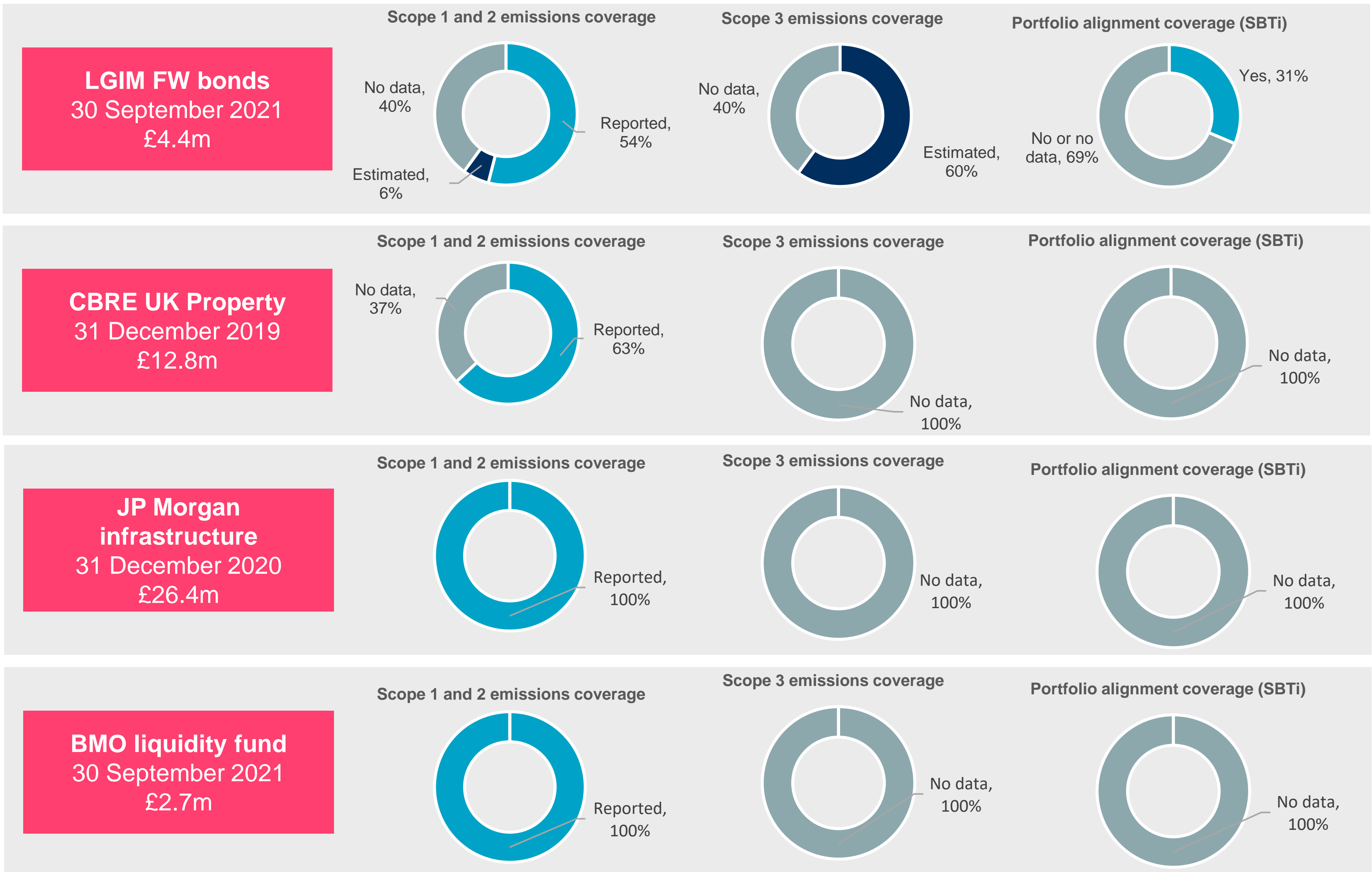
# *Section 4 – Metrics and Targets*

*Metrics – DB section:* Breakdown of data coverage. This is shown as the split of portfolio value analysed (not the split of the emissions figures).




Source: Investment managers, MSCI, LCP.

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# Section 4 – Metrics and Targets

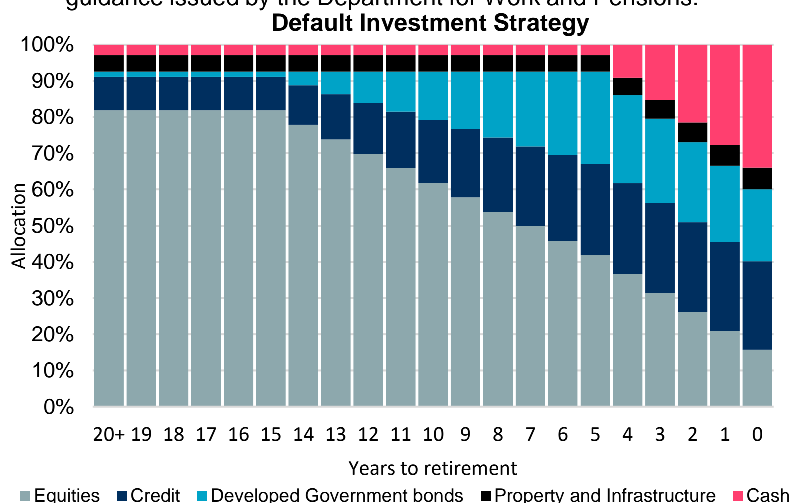
## Metrics – DC section

The Trustee's three chosen metrics are listed below and reported overleaf for the DC section (as far as the Trustee was able to obtain the data).

| Metric | High-level methodology[1] |
|---|---|
| **Absolute emissions: Total greenhouse gas emissions** | The sum of each company's most recent reported or estimated greenhouse gas emissions attributable to the Scheme's investment in the company, where data is available. Emissions are attributed evenly across equity and debt investors. Reported in tonnes of $CO_2$ equivalent. This methodology was chosen because it is in line with the statutory guidance. |
| **Emissions intensity: Carbon footprint** | The total greenhouse gas emissions described above, divided by the value of the invested portfolio in £m, adjusted for data availability. Emissions are attributed evenly across equity and debt investors. Reported in tonnes of $CO_2$ equivalent per £1m invested. This methodology was chosen because it is in line with the statutory guidance. |
| **Portfolio alignment: Emissions reduction targets** | The proportion of the portfolio by weight of companies that have a carbon emissions reduction target that has been approved by the Science Based Targets initiative or equivalent. Reported in percentage terms. The Trustee chose this "binary target" measure because it is the simplest and most robust of the various portfolio alignment metrics available. |

The data has been calculated using portfolio holdings as at 30 September 2021, using the most recent data available in November 2021, from the investment adviser's appointed climate metrics provider, MSCI.

The majority of DC assets are invested in the default strategy, with the assets allocated depending on members' expected retirement dates, as shown in the chart. As at 30 September 2021, 86% of DC assets were invested this way. The other assets are invested in a range of self-select funds, the largest allocation being c3.6% (£2.3m). The Trustee has not collected metrics for these other assets as it did not feel it was proportionate to do so. This is in line with the guidance issued by the Department for Work and Pensions.




**Default Investment Strategy coverage of 69%**

| Asset class (% of DC assets) | Details of missing data or estimations |
|---|---|
| **Equities (61%)** | See Appendix 2. |
| **Credit (16%)** | |
| **Government bonds (12%)** | There are gaps in reporting climate data for asset classes other than listed equities and listed corporate bonds. The Trustee is working with the investment managers to improve data reporting over time. In particular, for the default investment strategy, the Trustee expects to be able to report climate metrics in respect of government bonds and real assets, such as property and infrastructure, in the future. |
| **Property and Infrastructure (4%)** | |
| **Cash (8%)** | |

## *Metrics – DC section* (reported asset coverage of c69% of the DC Default Investment Strategy assets)

| Manager, asset class and valuation (£m) | | Portfolio value analysed (£m) | Scope 1 and 2 emissions | | | Scope 3 emissions | | | Emissions targets | Data source | Date of portfolio value and holdings |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Total GHG emissions ($tCO_2e$) | Carbon footprint ($tCO_2e$/£m) | Coverage | Total GHG emissions ($tCO_2e$) | Carbon footprint ($tCO_2e$/£m) | Coverage | Proportion with SBTi target (%) | | |
| **L&G Equities** | 29.7 | 29.3 | 2,462 | 52 | £47.4m/100% | 12,910 | 273 | £47.4m/100% | 43.1 | MSCI | 30/09/21 |
| **L&G DGF (Equities)** | 7.8 | 5.7 | 674 | 104 | £6.5m/98% | 2,413 | 373 | £6.4m/98% | 26.4 | MSCI | 30/09/21 |
| **L&G Corporate bonds** | 4.2 | 4.1 | 74 | 50 | £1.5m/37% | 522 | 345 | £1.5m/37% | 15.1 | MSCI | 30/09/21 |
| **L&G DGF (Credit, Alternatives, Cash)** | 11.1 | Not available | - | - | - | - | - | - | - | - | - |
| **L&G Gilts** | 9.7 | Not available | - | - | - | - | - | - | - | - | - |
| **L&G Cash** | 4.9 | Not available | - | - | - | - | - | - | - | - | - |

- The carbon footprint of L&G Equities is lower than for the equities held in the L&G DGF. Both funds track indices with specific Environmental, Social and Governance focus, however, the L&G Equities indices is more effective in reducing the carbon footprint of the fund. However, overall the majority of total emissions come from this allocation because of the large proportion of the Scheme's assets invested in it.

- The proportion of holdings with SBTi portfolio alignment targets is also highest for L&G Equities. The Trustee has a long-term target related to this metric which is shown on page 31.

- The Trustee continues to work with its investment managers to improve data reporting over time. The Trustee also considers both risks and opportunities related to carbon metrics when reviewing its investments.

Source: Investment managers, MSCI, LCP.

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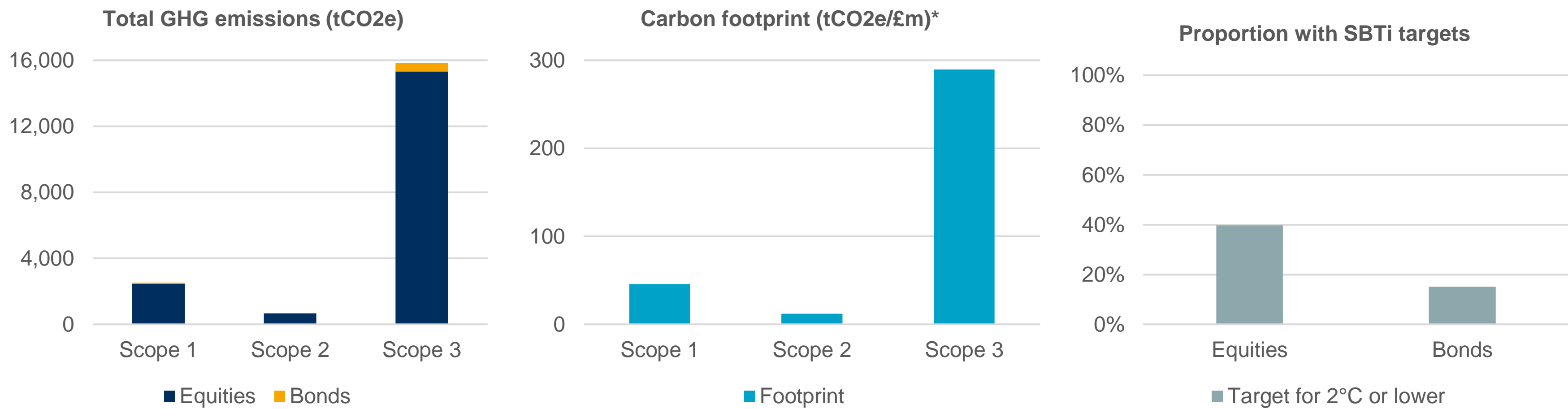
## *Metrics – DC section*

The charts below summarise the data shown on the page before. The next two pages give a breakdown of the data quality for the three metrics.




Source: Investment managers, MSCI, LCP. *Based on £1m invested in proportion to the Scheme's assets for which data is available.

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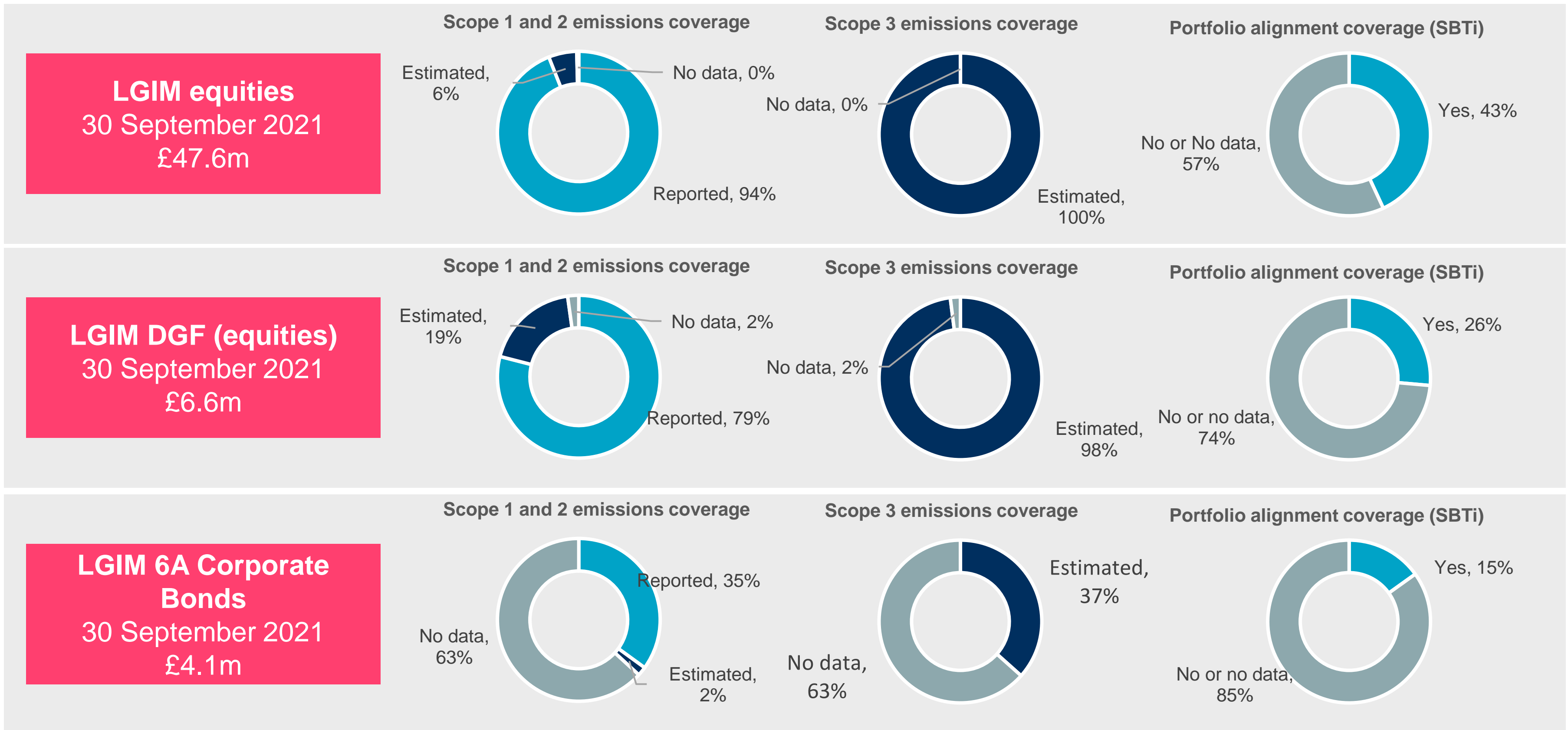
*Metrics – DC section:* Breakdown of data coverage. This is shown as the split of portfolio value analysed (not the split of the emissions figures).




Source: Investment managers, MSCI, LCP. *Based on £1m invested in proportion to the Scheme's assets for which data is available.
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## *Target*

The Trustee has set the following target:

| Target | DB Scheme coverage | DC Scheme coverage | Reference base year |
|---|---|---|---|
| **80% of listed equity and corporate bond investments to have set SBTi targets by 2030** | Listed equities and corporate bonds (c20% of total DB assets) | Listed equities and corporate bonds within the default investment strategy (c77% of total DC assets) | 2021 |

The climate reporting carried out for the Scheme during the year included an assessment of the current alignment with the above target. Broadly 21% of the DB section's listed equity and corporate bond investments and 35% of the DC section's listed equity and corporate bond investments within the default investment strategy have set SBTi targets by 2021, based on information held on the MSCI database. The Trustee assumes that no other portfolio companies have set SBTi targets.

The proportion of each fund with set SBTi targets was compared with the corresponding figure for a relevant market index with similar characteristics. Overall, the current proportion is considered to be broadly in line with the wider market. The analysis enabled the Trustee to identify the most appropriate funds and managers to focus their engagement on, which would result in the most significant improvement in the Scheme's alignment with its target.

The following steps are being taken to achieve the target:

- The Trustee, with help from its investment consultant, will communicate the target to each investment manager.
- Investment managers are routinely invited to present at Trustee meetings as part of the existing monitoring process. When meeting with any of the Scheme's investment managers, the Trustee will ask the manager how they expect the proportion of portfolio companies with SBTi targets to change over time and encourage the manager to engage with portfolio companies about setting SBTi targets, prioritising those with the highest carbon footprint.
- The investment consultant encourages managers to support the goal of net zero emissions by 2050 or earlier and has published its expectations for investment managers in relation to net zero. This includes the use of effective voting (where applicable) and engagement with portfolio companies to encourage achievement of net zero. The investment consultant continues to engage with managers on this topic and will encourage them to use their influence with portfolio companies to increase the use of SBTi targets.
- The Trustee will review progress towards the target each year and consider whether additional steps are needed to increase their chance of meeting the target.

Source: Investment managers, MSCI, LCP.
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# Appendices

- Appendix 1 – Climate Scenario Analysis Page 33
- Appendix 2 – MSCI data Page 40
- Appendix 3 – Glossary Page 41

# *Appendix 1 – Climate Scenario Analysis*

**Scenarios considered and why the Trustee chose them**

The Trustee carried out climate scenario analysis as at 31 December 2020 with the support of its actuarial and investment consultants, LCP. The analysis looked at three possible scenarios:

| Transition | Description | Why the Trustee chose it |
|---|---|---|
| Failed Transition | Paris Agreement goals not met; only existing climate policies are implemented | To explore what could happen to the Scheme's finances if carbon emissions continue at current levels and this results in significant physical risks from changes in the global climate that disrupt economic activity. |
| Paris Orderly | Paris Agreement goals met; rapid and effective climate action, with smooth market reaction | To see how the Scheme's finances could play out if the Paris Agreement goals are achieved, meaning that the economy makes a material shift towards low carbon by 2030. |
| Paris Disorderly | Same policy, climate and emissions outcomes as the Paris Orderly Transition, but financial markets are initially slow to react and then over-react | To look at the risks and opportunities for the Scheme if the Paris Agreement goals are met, but financial markets are volatile as they adjust to a low carbon economy. |

The Trustee acknowledges that many alternative plausible scenarios exist, but found these were a helpful set of scenarios to explore how climate change might affect the Scheme in future.

To provide further insight, the Trustee also compared the outputs under each scenario to a “climate uninformed base case”, that makes no allowance for either changing physical or transition risks in future.

The scenarios' key features are summarised on page 34.

These scenarios show that equity markets could be significantly impacted by climate change with lesser but still noticeable impacts in bond markets. All three scenarios envisage, on average, lower investment returns and these result in a worse DB funding position, or lower retirement outcomes for DC members.

# *Appendix 1 – Climate Scenario Analysis*

**The climate scenarios considered by the Trustee**

Scenarios as at 31 December 2020 – key features

| ***Scenarios:*** | ***Failed Transition*** | ***Paris Orderly Transition*** | ***Paris Disorderly Transition*** |
|---|---|---|---|
| **Low carbon policies** | Continuation of current low carbon policies and technology trends | Ambitious low carbon policies, high investment in low-carbon technologies and substitution away from fossil fuels to cleaner energy sources and biofuel | |
| **Paris Agreement outcome** | Paris Agreement goals not met | Paris Agreement goals met | |
| **Global warming** | Average global warming is about 2°C by 2050 and 4°C by 2100, compared to pre-industrial levels | Average global warming stabilises at around 1.5°C above pre-industrial levels | |
| **Physical impacts** | Severe physical impacts | Moderate physical impacts | |
| **Impact on GDP** | Global GDP is significantly lower than the climate-uninformed scenario in 2100.<br>For example, UK GDP in 2100 predicted to be 55% lower than in the climate uninformed scenario. | Global GDP is lower than the climate-uninformed scenario in 2100.<br>For example, UK GDP in 2100 predicted to be about 10% lower than in the climate-uninformed scenario. | In the long term, global GDP is slightly worse than in the Paris Orderly scenario due to the impacts of financial markets volatility. |
| **Financial market impacts** | Physical risks priced in over the period 2025-2030. A second repricing occurs in the period 2035-2040 as investors factor in the severe physical risks | Transition and physical risks priced in smoothly over the period of 2021-2025 | Abrupt repricing of assets causes financial market volatility in 2025 |

Source: Ortec Finance. Figures quoted are medians.

**Modelling approach**

- The scenario analysis is based on a model developed by Ortec Finance and Cambridge Econometrics. The outputs were then applied to the Scheme's assets and liabilities by LCP.
- The three climate scenarios are projected year by year, over the next 40 years.
- The results are intended to help the Trustee to consider how resilient the DB funding strategy, DB investment strategy and the DC default strategy are to climate-related risks.
- The Trustee discussed how future planned changes to the investment strategies for both Sections would change the analysis.
- The three climate scenarios chosen are intended to be plausible, not "worst case". Only three scenarios out of countless others which have been considered. Other scenarios could give better or worse outcomes for the Scheme.
- The results discussed in this report have been based on macro-economic data at 31 December 2020, calibrated to market conditions at 31 March 2021.

For more information about the modelling approach, see next page.

**Modelling limitations**

- As this is a "top-down" approach, investment market impacts were modelled as the average projected impacts for each asset class. This contrasts with a "bottom up" approach that would model the impact on each individual investment held by the Scheme's DB investment portfolio and DC default strategy. As such, the modelling does not require extensive scheme-specific data and so the Trustee was able to consider the potential impacts of the three climate scenarios for all of the Scheme's DB assets and DC assets in the default strategy.
- In practice, the Scheme's investments may not experience climate impacts in line with the market average.
- Like most modelling of this type, the modelling does not allow for all potential climate-related impacts and therefore is quite likely to underestimate some climate-related risks. For example, tipping points (which could cause runaway physical climate impacts) are not modelled and no allowance is made for knock-on effects, such as climate-related migration and conflicts.
- The Scheme currently has an insurance contract covering a significant proportion of the DB benefits payable to pensioners. As this contract exactly matches the DB benefits payable to members, it has been excluded from the analysis. The Trustee considered qualitatively how insurance contracts might be affected by climate risk.

## Modelling approach – more details

- The scenario analysis is based on the ClimateMAPS model developed by Ortec Finance and Cambridge Econometrics, and was then applied to the Scheme's assets and liabilities by LCP. The three climate scenarios were projected year by year, over the next 40 years.

- ClimateMAPS uses a top-down approach that consistently models climate impacts on both assets and liabilities, enabling the resilience of the DB section's funding strategy to be considered. The model output is supported by in-depth narratives that bring the scenarios to life to help the Trustee's understanding of climate-related risks and opportunities.

- ClimateMAPS uses Cambridge Econometrics' macroeconomic model which integrates a range of social and environmental processes, including carbon emissions and the energy transition. It is one of the most comprehensive models of the global economy and is widely used for policy assessment, forecasting and research purposes. The outputs from this macroeconomic modelling – primarily the impacts on country/regional GDP – are then translated into impacts on financial markets by Ortec Finance using assumed relationships between the macroeconomic and financial parameters.

- Ortec Finance runs the projections many times using stochastic modelling to illustrate the wide range of climate impacts that may be possible, under each scenario's climate pathway. LCP takes the median (ie the middle outcome) of this range of impacts, for each relevant financial parameter, and adjusts it to improve its alignment with LCP's standard financial assumptions.

- LCP then uses these adjusted median impacts to project the assets and liabilities of the Scheme to illustrate how the different scenarios could affect its funding level. The modelling summarised in this report used scenarios based on the latest scientific and macro-economic data at 31 December 2020, calibrated to market conditions at 31 March 2021.

- The modelling included contributions assumed to be paid in line with the current Schedule of Contributions, and the Trustee discussed how future planned changes to the investment strategies for both schemes would change the analysis. For the DC section, members' starting pots values were assumed to equal the average value for Scheme members of their age, and member and employer contributions were assumed to be paid in line with the current contribution structure. No allowance was made for changes to the investment strategy or contributions in response to the climate impacts modelled.

- As this is a "top-down" approach, investment market impacts were modelled as the average projected impacts for each asset class, ie assuming that the Scheme's investments are affected by climate risk in line with the market-average portfolio for the asset class. This contrasts with a "bottom up" approach that would model the impact on each individual investment held in the Scheme's investment portfolio. As such, it does not require extensive Scheme-specific data and so the Trustee was able to consider the potential impacts of the three climate scenarios for all of the Scheme's assets.

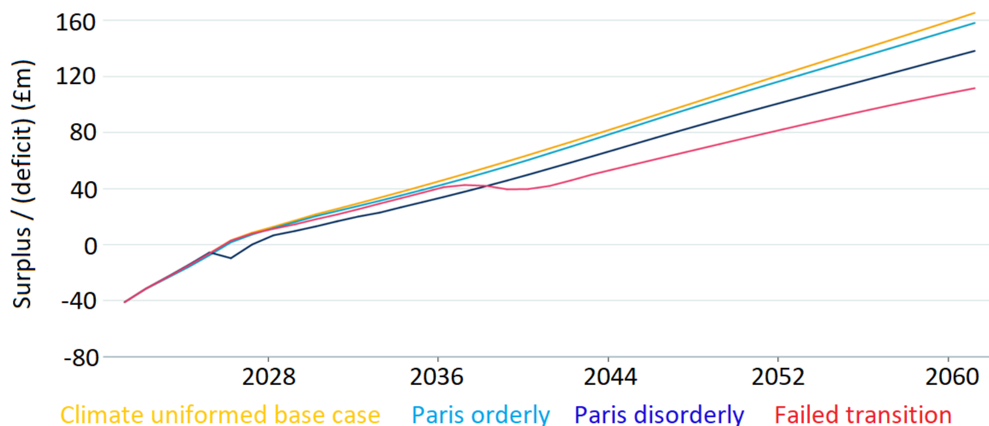
- In practice, the Scheme's investment portfolio may not experience climate impacts in line with the market average. The Trustee considers, on an ongoing basis, how the Scheme's climate risk exposure differs from the market average using climate metrics (which are compared with an appropriate market benchmark) and its annual responsible investment review which considers the investment managers' climate approaches (see page 17).

- The Trustee notes that the three climate scenarios chosen are intended to be plausible, not "worst case", and the modelling is based on median outcomes. It therefore illustrates how the centre of the "funnel of doubt" surrounding DB funding and DC asset projections might be affected by climate change. It does not consider tail risks within that funnel, nor does it consider how the funnel might be widened by the additional uncertainties arising from climate change. In addition, only three scenarios out of infinitely many have been considered. Other scenarios could give better or worse outcomes for the Scheme.

- Uncertainty in climate modelling is inevitable. In this case, key areas of uncertainty relating to the financial impacts include how climate change might affect interest rates and inflation, and the timing of market responses to climate change. ClimateMAPS, like most modelling of this type, does not allow for all climate-related impacts and therefore, in aggregate, is quite likely to underestimate the potential impacts of climate-related risks, especially for the Failed Transition scenario. For example, tipping points (which could cause runaway physical climate impacts) are not modelled and no allowance is made for knock-on effects, such as climate-related migration and conflicts.

### Potential Scheme impacts under each scenario – DB section

- The chart below illustrates the projected funding position of the DB section in each of the three scenarios considered, as well as in the "climate uninformed base scenario".
- Under the Paris Orderly Transition (bright blue line), there is minimal impact to the DB funding position as the costs and benefits of the transition are modelled as broadly cancelling out.
- Under the Paris Disorderly Transition (dark blue line), there is market volatility as the market reprices in the mid 2020s, but this has a relatively modest impact on the DB funding position (as the investment strategy has already largely de-risked away from the asset classes that are expected to be most exposed to climate risk).
- Under the Failed Transition (pink line), there would be a more significant impact on the funding position, but not until after 2035. In practice, this is after the Trustee aims to fully insure the Section's liabilities.




### Scenario outcomes

The scenario analysis highlighted a number of potential financial impacts for the DB section including:

- In the short term (next 5 years), climate impacts are expected to be fairly limited as the Scheme has a relatively low allocation to the asset classes that are expected to be most exposed to climate risk. However some scenarios could result in detrimental DB funding impacts relative to the base case (but noting in those instances there is still expected to be a funding surplus).
- In the medium and long term (ie over 5 years), the Trustee aims to fully insure the DB benefits with an insurer, which is expected to remove the longer term potential climate impacts of a Failed Transition from the Section and pass these risks to an insurer. Please see the section on the long-term DB funding target on the next page.
- In the event that the Trustee is unable to insure the remaining DB benefits with an insurer, all scenarios are expected to be detrimental to the DB funding position versus the base case over the long term (albeit in a large proportion of scenarios with the Section remaining in surplus). Furthermore, any future de-risking of the investment strategy, which would be likely if the funding surplus were to materialise, will be an important mitigation tool to reduce the level of climate change exposure.

**Impact of climate change on life expectancy for the DB section**

If a member lives longer, the Scheme pays the member's DB pension for longer and therefore needs more assets to make the payments.

Like the economic impacts, the impact of climate change on life expectancy is highly uncertain. As part of the discussions on the climate scenario analysis, the Trustee considered the various possible drivers for changes in mortality rates with both positive and negative impacts expected in each of the scenarios considered.

For example, in the Paris Orderly scenario, the reduced use of fossil fuels should lead to lower air pollution, increasing life expectancy. But this effect could be countered by economic prosperity generally being lower in this scenario, and this may limit the funding available for healthcare.

Given the level of uncertainty, the Trustee noted that no specific allowance has currently been made in the scenario analysis, but that it would keep up to date on developments in this area and consider it further at the next actuarial valuation.

**Long term DB funding target (insurance buyout)**

The Trustee also discussed the possible impact of climate change on its long term DB funding target. In particular, the Trustee considered how climate change risks could affect insurer pricing for securing pension benefits. A change in insurer pricing levels could have a significant impact on when it will be feasible to secure benefits with an insurer. Future insurance pricing is inherently uncertain, so the Trustee will continue to monitor it going forward and as they get closer to a possible transaction.

The main influence of the climate scenario analysis was to highlight that the sooner the Scheme can implement an insurance transaction to cover the whole DB section membership, the less likely climate change risks would result in members not receiving their full benefits. This is because of the additional regulatory protections that apply to insurance policies. The Trustee noted that climate change increases the chance that these regulatory protections are insufficient, although it believes this possibility is still very unlikely.

**Potential Scheme impacts under each scenario – DC section**

The scenario analysis looked at the retirement outcomes (in terms of the size of their retirement pot) for individual members of different ages who are invested in the default strategy (see page 27 for details of the strategy). The analysis highlighted that members in the DC section will be subject to climate risks to varying degrees depending on the climate scenario. In general, the default strategy has been designed in a way which reduces investment risk as members approach retirement. Climate risks are generally expected to have the greatest impact on return-seeking assets such as equities. In the default strategy, exposure to these assets is reduced as members approach retirement, which should help to reduce their exposure to climate risks.

- the Paris Orderly scenario leads to the best outcome for members as in this scenario the climate risks are relatively low.
- The Paris Disorderly scenario includes a market shock in the short term which impacts return-seeking assets the most. This has a muted impact on most members' retirement pots as they have time to recover through future investment returns and contributions. Members within 10 years of retirement hold a low and decreasing amount of return-seeking assets so they are impacted less than younger members under this scenario.
- The Failed Transition scenario has limited short term effects but larger long term effects as it assumes increasingly severe physical impacts of climate change emerge over time. This scenario particularly impacts younger members who remain invested in the Scheme for longer.

The analysis confirmed the importance of managing climate-related risks to members' pots. The Trustee does this by: ensuring the Scheme's investment managers have strong climate practices (see pages 17-18); reducing members' exposure to return-seeking assets as they approach retirement (see chart on page 27); and using stewardship to encourage the companies the Scheme invests in to improve their climate practices (see page 16).

**Table showing impact on member pots at retirement with different scenarios and starting ages**

| Scenario | Member aged 25 | Member aged 35 | Member aged 45 | Member aged 55 |
|---|---|---|---|---|
| **Paris Orderly outcome** | -5.9% | -3.0% | -1.2% | -0.8% |
| **Paris Disorderly outcome** | -7.9% | -5.9% | -4.9% | -4.2% |
| **Failed Transition outcome** | -22.7% | -19.1% | -11.2% | -1.4% |

# *Appendix 2 – MSCI data*

**Notes for data sourced from MSCI (shown on pages 23-26 and 28-30)**
The portfolio value analysed excludes holdings that were not covered by MSCI's database such as cash, sovereign bonds, bonds that have recently matured, or shares in companies no longer listed when the analysis was undertaken. Emissions are attributed to investors using "enterprise value including cash" (ie EVIC, the value of equity plus outstanding debt plus cash). Emissions coverage statistics are given as a % of the portfolio analysed. Coverage is not available for the SBTi metric because the MSCI database does not distinguish between companies which do not have an SBTi target and companies for which the SBTi status is not known.

The total GHG emissions figures omit any companies for which data was not available. For example, if the portfolio was worth £10m and emissions data was available for 70% of the portfolio by value, the total GHG emissions figure shown relates to £7m of assets and the portfolio's carbon footprint equals total GHG emissions divided by 7. In other words, no assumption is made about the emissions for companies without data.

The emissions targets metric refers to the % of portfolio by weight of companies that have a near-term carbon emissions reduction target that has been approved by the Science Based Targets initiative. Science-based targets provide a clearly defined pathway for companies to reduce greenhouse gas emissions which is in line with what the latest climate science deems necessary to meet the goals of the Paris Agreement – limiting global warming to well below 2°C above pre-industrial levels and pursuing efforts to limit warming to 1.5°C.

**Emissions data coverage and quality**

Where coverage of the portfolio analysed is less than 100%, this is because either:

- The MSCI database does not hold emissions data for some portfolio companies because the company does not report it and MSCI does not estimate it; or
- The MSCI database does not hold EVIC data for some portfolio companies, so emissions cannot be attributed between equity and debt investors.

The second of these reasons is the main explanation for the fairly low coverage of bond portfolios.

Where emissions data is estimated, MSCI uses one of three methods.

- For electric utilities, MSCI's estimate of Scope 1 emissions is of direct emissions due to power generation, calculated using power generation fuel-mix data.
- For companies not involved in power generation, which have previously reported emissions data, MSCI starts with a company-specific carbon intensity model.
- For other companies, MSCI uses an industry segment-specific carbon intensity model, which is based on the estimated carbon intensities for 1,000+ industry segments.

For Scope 3 emissions, we have chosen to use MSCI's estimated emissions even where reported emissions are available. This provides greater consistency than using a mixture of reported and estimated emissions. Analysis of reported Scope 3 emissions suggests that the data quality is currently low: data is volatile and often out of date, with relatively few companies reporting on all types of Scope 3 emissions. In contrast, MSCI estimates all types of Scope 3 emissions for most companies in its database, for a recent reporting year and using a consistent approach.

MSCI is a leading provider of climate-related data, so we would expect the coverage to compare favourably with other data sources. Our investment consultant is engaging with MSCI to encourage them to improve EVIC coverage for debt issuers and to distinguish between companies which do not have an SBTi target and companies for which the SBTi status is not known.

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# Appendix 3 – Glossary

**Actuarial valuation** – an actuarial valuation is an accounting exercise performed to estimate future liabilities arising out of benefits that are payable to members of a DB pension scheme, typically once every three years. In the actuarial valuation exercise, a liability pay-out at a future date is estimated using various assumptions such as discounting rate and salary growth rate.

**Asset class** – a group of securities which exhibit broadly similar characteristics. Examples include equities and bonds.

**Bond** – a bond is a security issued to investors by companies, governments and other organisations. In exchange for an upfront payment, an investor normally expects to receive a series of regular interest payments plus, at maturity, a final lump sum payment, typically equal to the amount invested originally, or this amount increased by reference to some index.

**Buy-in –** DB pension scheme trustees may choose to "buy-in" some of their scheme's expected future benefit payments by purchasing a bulk (ie one covering many individuals) annuity contract with an insurance company. This allows the trustees to reduce their scheme's risk by acquiring an asset (the annuity contract) whose cash flows are designed to meet ie "match" a specified set of benefit payments under the pension scheme. The contract is held by the trustees and responsibility for the benefit payments remains with the trustees. Common uses of buy-in arrangements have been to cover the payments associated with current pensioners or a subset of those members. Contracts to meet payments to members who are yet to become pensioners can also be purchased.

**Buy-out** – DB pension scheme trustees may choose to "buy-out" some or all of their scheme's expected future benefit payments by purchasing a bulk (ie one covering many individuals) annuity contract from an insurance company. The insurer then becomes responsible for meeting pension benefits due to scheme members (effected ultimately by allocating to each scheme member an individual annuity contract). Following a full buy-out, (ie one covering all scheme members) and having discharged all of the trustees' liabilities, the pension scheme would normally be wound up.

**Carbon emissions -** These refer to the release of carbon dioxide, or greenhouse gases more generally, into the atmosphere

**Carbon footprint** – In an investment context, the total carbon dioxide or greenhouse gas emissions generated per amount invested (eg in £m) by an investment fund. Related definitions are used to apply the term to organisations, countries and individuals

**Covenant** – the ability and willingness of the sponsor to make up any shortfall between a DB scheme's assets and the agreed funding target.

**Credit** – long-term debt issued by a company, also know as corporate bonds. Corporate bonds carry different levels of credit risk which is indicated by their rating and credit spread.

**Defined Benefit (DB)** – a pension scheme in which the primary pension benefit payable to a member is based on a defined formula, frequently linked to salary. The sponsor bears the risk that the value of the investments held under the scheme fall short of the amount needed to meet the benefits.

**Defined Contribution (DC)** – a pension scheme in which the sponsor stipulates how much it will contribute to the arrangement which will depend upon the level of contributions the member is prepared to make. The resultant pension for each member is a function of the investment returns achieved (net of expenses) on the contributions and the terms for purchasing a pension at retirement. In contrast to a defined benefit scheme, the individual member bears the risk that the investments held are insufficient to meet the desired benefits.

**Debt** – money borrowed by a company or government which normally must be repaid at some specified point in the future.

**Default strategy** – the fund or mix of funds in which contributions in respect of a DC member will be invested in the absence of any explicit fund choice(s) of that member.

# Appendix 3 – Glossary

**Environmental, social and governance (ESG)** – an umbrella term that encompasses a wide range of factors that may have been overlooked in traditional investment approaches. Environmental considerations might include physical resource management, pollution prevention and greenhouse gas emissions. Social factors are likely to include workplace diversity, health and safety, and the company's impact on its local community. Governance-related matters include executive compensation, board accountability and shareholder rights.

**Equity** – through purchase on either the primary market or the secondary market, company equity gives the purchaser part-ownership in that company and hence a share of its profits, typically received through the payment of dividends. Equity also entitles the holder to vote at shareholder meetings. Note that equity holders are entitled to dividends only after other obligations, such as interest payments to debt holders, are first paid. Unlike debt, equity is not normally contractually repayable.

**Ethical investment** – an approach that selects investments on the basis of an agreed set of environmental, social and governance (ESG) criteria that are motivated by ethical considerations. These can be positive – eg choosing companies involved in water conservation or negative – eg not choosing companies involved in the arms trade.

**Fiduciary obligations** – a legal obligation of one party (a fiduciary) to act in the best interest of others. Fiduciaries are people or legal entities that are entrusted with the care of money or property on behalf of others. They include pension scheme trustees.

**Fossil fuels** – fuels made from decomposing plants and animals, which are found in the Earth's crust. They contain carbon and hydrogen, which can be burned for energy. Coal, oil, and natural gas are examples of fossil fuels.

**Funding position** – a comparison of the value of assets with the value of liabilities for a DB pension scheme.

**Gilts –** bonds issued by the UK government. They are called gilts as the bond certificates originally had a gilt edge to indicate their high quality and thus very low probability of default

**Greenhouse gas (GHG) emissions (scopes 1, 2 and 3)** – gases that have been and continue to be released into the Earth's atmosphere. Greenhouse gases trap radiation from the sun which subsequently heats the planet's surface (giving rise to the "greenhouse effect"). Carbon dioxide and methane are two of the most important greenhouse gases.

**Investment mandate –** see pooled mandate and segregated mandate

**Integrated risk management** – Integrated risk management is an approach used by DB pension scheme trustees to identify, manage and monitor the wide range of risks (relating to investment, funding and covenant) which might impact the chances of meeting their scheme's overall objectives

**Liabilities** – obligations to make a payment in the future. An example of a liability is the pension benefit 'promise' made to DB pension scheme members, such as the series of cash payments made to members in retirement. The more distant the liability payment, the more difficult it often is to predict what it will actually be and hence what assets need to be held to meet it.

**LDI (Liability Driven Investment)** – an investment approach which focusses more than has traditionally been the case on matching the sensitivities of a DB pension scheme's assets to those of its underlying liabilities in response to changes in certain factors, most notably interest rate and inflation expectations.

**Net zero** – this describes the situation in which total greenhouse gas emissions released into the atmosphere are equal to those removed. This can be considered at different levels, eg company, investor, country or global.

# Appendix 3 – Glossary

**Paris Agreement** – the Paris Agreement is an international treaty on climate change, adopted in 2015. It covers climate change mitigation, adaptation and finance. Its primary goal is to limit global warming to well below 2°C, preferably to 1.5°C, compared to pre-industrial levels.

**Physical risk** – these are climate-related risks that arise from changes in the climate itself. They include risks from more extreme storms and flooding, as well as rising temperatures and changing rainfall pattens.

**Pooled mandate** – a feature of a collective investment vehicle whereby an investor's money is aggregated (ie "pooled") with that of other investors to purchase assets. Investors are allotted a share of those assets in proportion to their contribution. Ownership is represented by the number of "units" allocated – eg if the asset pool is worth £1m and there are 1m units then each unit is worth £1. Pooled funds offer smaller investors an easy way to gain exposure to a wide range of investments, both within markets (eg by buying units in a UK equity fund) as well as across markets (eg by buying units in both a UK equity fund and a UK corporate bond fund).

**Responsible Investment (RI)** – the process by which environmental, social and governance (ESG) issues are incorporated into the investment analysis and decision-making process, and into the oversight of investments companies through stewardship activities. It is motivated by financial considerations aiming to improve risk-adjusted returns.

**Science-based targets** – targets to reduce greenhouse gas emissions that are in line with what the latest climate science deems necessary to meet the goals of the Paris Agreement.

**Scenario analysis –** a tool for examining and evaluating different ways in which the future may unfold.

**Segregated mandate** – a segregated investment approach ensures that an investor's investments are held separately from those of other investors. This approach offers great flexibility – for example, the investor can stipulate the precise investment objective to be followed and can dictate which securities can or cannot be held.

**Self-select** – in contrast with a default fund, a self-select fund within a DC scheme is one of a range of funds that members can choose to invest in.

**Stakeholder** – an individual or group that has an interest in any decision or activity of an organisation. The stakeholders of a company include its employees, customers, suppliers and shareholders.

**Statutory obligations** – statutory obligations are those obligations that do not arise out of a contract, but are imposed by law.

**Stewardship** – stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society. It is often implemented via engagement with investee companies and exercising voting rights.

**Taskforce on Climate-related Financial Disclosures (TCFD) –** a group of senior preparers and users of financial disclosures from G20 countries, established by the international Financial Stability Board in 2015. The TCFD has developed a set of recommendations for climate-related financial risk disclosures for use by companies, financial institutions and other organisations to inform investors and other parties about the climate-related risks they face.

**Transition risk** – these are climate-related risks that arise from the transition to a low-carbon economy and can include changes in regulation, technology and consumer demand.