

Key principles for preparing climate scenario analysis as part of the 2025 valuation

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1. Background and scope of the analysis

- 1.1. The principles have been drafted and agreed between the four actuarial firms providing funding advice to the LGPS namely Aon, Barnett Waddingham, Hymans Robertson and Mercer at the request of GAD to ensure a consistent basis on the scenario analysis used by funds.
- 1.2. The principles should be reviewed in advance of every triennial valuation and any amends should be agreed with the different actuarial firms and MHCLG, SAB and GAD. Commentary on compliance with the principles will be included in the Section 13 review following each triennial valuation.
- 1.3. An important part of any analysis for the valuations will be to identify the impact of transition risk (shorter term) and physical risks (longer term) on the potential funding outcomes. It is therefore critical that any analysis covers an appropriate spectrum of outcomes e.g. degree of warming/rate of transition to low carbon state and also timeframe of analysis. This is the fundamental principle of how the core analysis should be considered.
- 1.4. Funds will consider at the outset the scope of the analysis to be undertaken and the scenarios to be considered at the Whole Fund level, comprising at least two alternate scenarios covering differing rates of transition. These may be considered relative to a base scenario (i.e. with implicit adjustment to assumptions for scenarios which include varying degrees of climate change transition, consistent with the funding assumptions). This might be used, for example, to test whether the funding strategy is sufficiently robust in the context of the scenario analysis considered and therefore any potential contribution impacts.
- 1.5. This quantitative analysis should be supported by a qualitative commentary on the financial risks under each scenario, for example the impact on asset classes, inflation, life expectancy, interest rates, and how these may impact the funding level. The qualitative commentary could also include detail of how a Fund has considered, and managed, the financial risks that the Fund may be exposed to, and any potential actions being taken to improve resilience to climate change.

2. Scenarios to be considered

- 2.1. At least two scenarios should be considered covering a range of physical and transition risk including one Paris aligned scenario and one high temperature scenario.
- 2.2. Funds should consider both the projected potential global average temperature rise, and the nature of the transition to that temperature rise (e.g. timing and level of disruption).

2.3. Ultimately Funds will take advice from their Fund Actuary (and other advisers as appropriate) on the analysis to be undertaken as part of the valuation.

2.4. The detailed method and assumptions underpinning the climate change scenarios is not prescribed and will be determined by Funds working with their advisers based on their own plans to address climate change. However, as an example, the following impacts may be considered:

2.4.1. the potential impact on the future investment return outlook (and therefore discount rate) and inflation (and therefore inflation-linked assumptions), for the purpose of projecting liability values; and

2.4.2. the impact on the investment returns delivered by the Fund's investment strategy for the purpose of projecting asset values

2.4.3. Funds could also consider with their advisers the extent to which the scenarios will consider additional elements such as that set out in section 4.2.

2.5. As well as Funds having different approaches to dealing with climate change in their portfolio construction, it is recognised that different actuarial firms/GAD will legitimately have differing views on the methodology and assumptions underpinning different climate change scenarios although we would expect some commonality here.

3. Time horizon and output

3.1. The output from the scenarios will include quantitative consideration of the results over a period of at least 20 years to ensure there is sufficient recognition of the transition and physical risks of climate change. Funds can opt for a longer time horizon as appropriate.

3.2. To ensure consistency with other reporting requirements, if a Fund chooses to do so then separate analysis could be undertaken to be consistent with the expected TCFD requirements i.e. giving consideration to the short, medium and long term impacts, but this would be subject to the final TCFD requirements for the LGPS.

4. Reporting

4.1. The Fund Actuary will summarise the analysis/commentary in the final valuation report, including the headline assumptions underpinning the analysis, in line with the profession's expectations. Reference should be made to the challenges and limitations that users of scenario analysis should be aware of when interpreting results, as per the guidance from the Institute and Faculty of Actuaries.

4.2. As part of the commentary in the final valuation report, fund actuaries could include detail on what risks have been considered within the scenarios modelled and how the Fund has used the output of the scenario modelling in the valuation results. For example, if the fund has considered the potential impact of climate change on life expectancy changes in setting demographic assumptions, or if the fund has integrated climate risk into its employer

covenant analysis which informed the employer contributions, this could be set out in the report.

- 4.3. Under each of the scenarios considered, detail on the temperature alignment of the scenarios modelled and the timescales for transition, should be included.
- 4.4. As part of the dashboard, Funds will be required to note whether or not climate change analysis has been included in the final valuation report for consideration by GAD for Section 13 reporting requirements. Given the different possible approaches and scenarios the results should not be used to comment on differences in impacts across funds.
- 4.5. If a Fund chooses to exclude this analysis from the final valuation report then the Fund should include a statement with a short explanation within the report.
- 4.6. Funds should be required to include in their Funding Strategy Statement a statement that the Fund has undertaken scenario analysis to assess the resilience of the strategy against climate change risk over the agreed period. This statement could also include:
 - 4.6.1. commentary on how the climate risk analysis is integrated into a fund's overall funding risk management strategy and decision-making.
 - 4.6.2. commentary on where it has managed non-financial climate risk more generally.

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