The Taskforce on Climate-related Financial Disclosure

INVESTOR BRIEFING

The Investor Group on Climate Change (IGCC) has been promoting better corporate disclosure on climate change for over a decade.

Climate change, and carbon risk, is a foreseeable financial risk. There are now clear international and national policy pathways, with probable market and technological implications and flow through physical risk impacts. Companies have the ability to assess likely scenarios and stress test their business strategy against them. Effective anticipation of likely pathways and the market response will directly impact financial returns and differentiate the relative performance of companies within industry sectors.

Investors increasingly want to see that analysis being done by the companies they hold, and the results discussed before they are prepared to invest their capital. A weak carbon risk management strategy can be priced into investment decisions. New low carbon opportunities can be strategically pursued.

The market has the capacity to absorb the significant structural adjustments required to decarbonize the economy over time if there is a reasonable level of carbon risk disclosure. Inadequate disclosure could lead to sudden movements of capital or the abrupt devaluation of assets with the potential to impact the broader market.

Building standardised carbon risk disclosure is key to managing the economic risks of climate change.

What is the TCFD?

At the request of the G20, the Financial Stability Board (FSB) chaired by Mark Carney of the Bank of England has been examining how the financial sector can better incorporate climate-related issues into decision-making by companies, insurers, investors and other important actors in the financial system.

In December 2015, the FSB formally established the Task Force on Climate-Related Financial Disclosures (TCFD), to be chaired by Michael Bloomberg. Members of the TCFD include capital providers, corporate reporters and business, accounting firms and rating agencies.

The Objective of the TCFD is to promote climate-related disclosures that:

1. Support **informed** investment, credit and insurance underwriting **decisions** about reporting companies
2. Enable a variety of stakeholders to **understand** the concentrations of **carbon-related assets** in the financial sector and the financial system's **exposures** to climate-related risk

Financial Stability Board (2015, November 9). Proposal for a disclosure task force on climate-related risks.

The intent of the TCFD is to undertake an assessment of the current state of climate-related risk disclosures and to design a set of voluntary recommendations to help shape best practices for disclosure going forward.

The TCFD has been undertaking a year-long process of review, issuing the first draft report for *Phase 1* in April, followed by a month-long consultation process. The *Phase 2* report, released in December, sets out specific recommendations and guidelines for disclosure for further consultation. The final report goes to the G20 in May 2017.

Defining carbon risk

The term *carbon risk* has undergone a number of iterations over time as the market has sought to understand and articulate the dimensions of financially-relevant risk being assessed.

Today, the terminology employed by the TCFD has become the cornerstone of discussions on improving the quality of carbon risk disclosure. This focuses on Transition, Physical and Liability risks.

Transition risks: the financial risks which could result from the process of adjustment towards a lower carbon economy. This includes policy and legal risks, technology, market and reputation risks, with the potential to drive a reassessment of values for a large range of assets as costs and opportunities emerge.

Physical risks: the impacts that arise from climate and weather related events, such as floods and storms that damage property or disrupt trade, and expected changes to the frequency and severity of these events. These are divided between *acute* risks which are event driven, and *chronic* risks which are longer term shifts in climate patterns.

The materiality of each of these dimensions of carbon risk will vary from industry sector to sector. But a commonly understood and applied definitional framework for carbon risk is a critical first step to improving carbon-related financial disclosure.

Identifying climate opportunities

Just as important as managing risk is realising new investment opportunities. Many companies will benefit from new products and services implemented to mitigate or adapt to climate change, through energy efficiency or cost savings for example. These opportunities can be categorized as resource efficiency, changing energy courses, products and services or new markets. Disclosure frameworks are just as important for climate related opportunities as they are for identifying financial risks.

The problem with disclosure today

For investors assessing company performance, key dimensions of climate related performance are chronically underreported, ill-defined, incomplete, immaterial, out of date or inconsistently disclosed.

There is currently not a common understanding or definition for the parameters and components of financially-relevant 'carbon risk' for the purposes of disclosure. The two most common approaches in Australia, include adopting a compliance based approach to emissions reporting (using NGERs) or incorporating a broad-based climate change position statement into ESG or sustainability reporting. There are a limited number of companies who have effectively embedded financially-relevant carbon risk disclosure into financial reporting in a meaningful way.

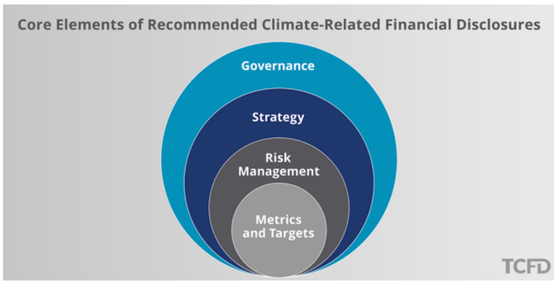
Gaps in carbon disclosure identified by the TCFD have included fragmentation, consistency of approach, usefulness and alignment with financial practices and some technical barriers to reporting. Specifically, ensuring better disclosure of the financial implications of climate performance parameters is a key outcome of the taskforce.

What is the TCFD recommending?

For all industry sectors, the recommendations will be structured around four key areas:

1. **Governance**: Set out the organisation's governance framework for managing climate change
2. **Strategy**: Disclose the potential impacts of climate change risks/opportunities on the organisation's business strategy, operations and financial planning short/medium/long terms
3. **Risk Management**: Disclose how the organisation identifies, assesses and manages climate related risks
4. **Metrics and targets**: disclose the metrics and targets used to assess and manage climate climate-related risks and opportunities.

These four thematic areas are accompanied which apply to all sectors, are accompanied by Supplemental Guidance for Financial and Non-Financial Sectors, including for Banks, Insurance Companies, Asset Owners, Asset Managers, Energy, Transportation, Materials and Buildings and Agriculture, Food and Forest Products.



The taskforce encourages companies to set out a response for these categories against the parameters of carbon risk identified earlier as transition, physical and liability risk, subject to where they are financially material and over what timeframe.

The intent is not to duplicate or replace existing work, but rather to build on momentum underway. The taskforce has explicitly aligned or cross-linked with existing reporting frameworks or standards where possible, such as the Climate Disclosure Standards Board (CDSB), French Energy Transition Law, CDP, SASB of Science-based Targets, for example.

Scenario Analysis

One of the key issues for the taskforce has been increasing investor calls for companies to publish future focused 'scenario analysis' and to address the challenges of forward looking disclosure.

The Taskforce is explicitly recommending that organisations use scenario analysis to assess potential business, strategic, and financial

implications of climate change related risks and opportunities in their financial filings.
The taskforce recommends the use of a 2°C scenario, along with two or three additional scenarios most relevant to their circumstances (such as national policies, BAU or other industry scenarios).

"INVESTORS NEED TO SEE THE STRATEGIC AS WELL AS THE STATIC" MARK CARNEY

The report includes detailed guidance and a separate additional paper on selecting and applying different approaches to Scenario Analysis. This will be a key areas of focus in further consultation.

This 'two-degree stress testing' of scenario analysis allows investors to assess the vulnerability of companies to different decarbonisation pathways, assess their strategic response and more accurately price the associated financial risk. 'Metrics and Targets' is also intended to address how companies are pursuing the opportunities arising from climate change

The taskforce has not sought to tackle systemic risk, beyond acknowledging the role that the FSB has in managing these issues and aggregating up and reviewing the system-wide implications of specific issuer and industry level disclosure.

Implementation

The Taskforce has accurately identified that adoption of the recommendations is critical. It singles out the G20 and FSB as having a critical role to play in promoting the widespread adoption of the recommendations to improve the 'functioning of the financial system'. The report includes an illustrative timeline for implementation over five years.

Why is the TCFD so important?

The work of the Task Force is particularly timely following the entry into force of the Paris Agreement, expanding policy responses to climate change, accelerating energy transition and evidence of increasing climate impacts.

Australia, along with over 190 other nations, has committed to limit global warming to less than two degrees. This will have significant market and economic implications.

Establishing harmonised disclosure frameworks for the measurement and reporting of climate change risks and opportunities will be key to mobilizing capital and pricing risk as the world moves to a net zero emissions economy.

Without the right information, the transition will still happen, but it will be messy, inefficient, expensive and inequitable as markets scramble to respond.

Finally, for Australia, it is vital that Australian corporate practice and practical experience is consistent with global practice as set out in the global disclosure framework.

IGCC has previously set out key issues and considerations for Australian reporting in a submission to the Senate Inquiry into Carbon Risk Disclosure.

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Why do investors care about this?

Investors rely upon companies reporting material, complete and comparable climate change disclosure to make informed decisions and price risk accurately. To date, corporate disclosure has been patchy, shallow and not always financially material.

As part of the year-long engagement process, investors advocated that companies adopt a risk management and disclosure approach that includes both narrative and quantitative disclosure of climate risk information.

Reporting needs to cover relatively long time horizons, reflective of the challenge of climate change.

Carbon risk should incorporate both transitional and physical risk dimensions. Emissions data should include Scope 1,2 and where appropriate Scope 3 emissions.

Reporting should be forward-looking and risk-based. Investors identified that 2 degree stress-testing in sectors where climate change is expected to have a material impact will be necessary.

We also acknowledged that investor climate change disclosure needs to be strengthened across the industry.

What happens next?

The draft Phase Two report, released on 14 December, is open for further consultation for 60 days. The final report will be delivered to the FSB in March and to the G20 meeting in Germany in 2017.

Companies, investors and regulators in markets all round the world will likely be reviewing the recommendations with a view to adopting some or all of the proposed disclosure framework.

IGCC RECOMMENDATIONS

IGCC believes that there are a number of opportunities to improve the quality of corporate carbon risk disclosure:

Companies should review their current corporate climate disclosure practices against the recommendations of the TCFD

Government should review current corporate disclosure frameworks and embed the recommendations of the TCFD

Investors need to strengthen their own reporting by adopting the recommendations of the TCFD