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TCFD Report Will Shape Future Expectations for Climate-Related Financial Disclosures

On June 29, 2017, the Task Force on Climate-Related Financial Disclosures (TCFD or Task Force) released its Final Report providing recommendations on voluntary climate-related financial disclosures. The recommendations, developed by an industry-led task force of both users and preparers of disclosures, are intended to support the production of more consistent and clear financial disclosure of climate-related risks across sectors for use by investors, lenders, and insurers. Most G20 countries have existing legal frameworks that require the disclosure of material risks in financial reports. Beyond legal mandates, investors are increasingly focused on environmental, social, and governance (ESG) factors in evaluating potential investments and future business risk. While the Task Force's recommendations are voluntary and independent of the environmental sustainability disclosure standards currently under review in the U.S. by the Securities and Exchange Commission (SEC) (*see* Beveridge & Diamond alert on the SEC concept release), the recommendations will impact the approach many publicly traded companies take to data collection and climate risk reporting over the long-term.

Background and Intended Usage

The G20 Financial Stability Board (FSB) created the Task Force in December 2015 at the request of the G20 Finance Ministers and Central Bank Governors to develop recommendations to improve the data provided to assess, price, and manage climate-related risks and opportunities. The Task Force, chaired by Michael Bloomberg, consists of 32 members chosen by the FSB from various countries, representing large financial companies, large non-financial companies, accounting and consulting firms, and credit rating agencies.

The recommendations apply across sectors, including financial-sector organizations such as banks, insurance companies, asset managers, and asset owners, as well as non-financial industries. In developing the recommendations, the Task Force solicited feedback from interested parties through two public comment periods that garnered over 500 responses, hundreds of industry interviews, and numerous focus groups and webinars. The Task Force published a draft report in December 2016 and received over 300 comments from commenters in 30 countries, which were used to refine the final recommendations. *See* summary of the public consultation process prepared by the Task Force; *see also* Section E of the Final Report, which summarizes the key points raised by industry and discusses substantive changes to the report from the draft version.

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In addition to the Final Report containing the recommendations, the Task Force also released two additional supporting documents: 1) an annex providing guidance on implementation ("Implementing the Recommendations of the Task Force on Climate-Related Financial Disclosures" (hereinafter "Annex")); and 2) a technical supplement that provides further detail to companies on how to perform climate scenario analysis ("The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities").

Final Recommendations: Summary of Key Elements

Generally, the process of preparing the disclosure should solicit forward-looking information on potential financial impacts of climate change, with a focus on the risks and opportunities inherent in a transition to a lower carbon economy. The recommendations divide climate-related risks into two major groups: A) physical, i.e., acute events and chronic changes; and B) transition risks, which include legal and policy changes to address climate change; technological changes inherent in a shift to a lower carbon economy; market shifts based on supply chain changes and customer demand shifts; and general reputational shifts that might lead to lower investment and revenue for certain industries.

The Task Force organized its recommendations into four thematic areas: 1) governance; 2) strategy; 3) risk management; and 4) metrics and targets, each of which is discussed below. In addition to these overarching recommendations, the Task Force developed specific recommended financial disclosures, or "recommended disclosures," that support the four thematic areas, as well as guidance for all sectors that suggests ways to implement the recommendations (as detailed in the Annex). Finally, the Task Force created supplemental guidance for the financial sector (defined as banks, insurance companies, asset managers, and asset owners), and for non-financial industries accounting for the largest proportion of greenhouse gas emissions (energy; materials and buildings; transportation; and agriculture, food, and forest products).

1. *Governance*

The recommendations encourage organizations to disclose their governance policies around climate-related risks and opportunities. Final Report at 19. The Task Force recommended two disclosures: 1) describe the board's oversight of climate-related risks and opportunities; and 2) describe management's role in assessing and managing such risks and opportunities. The guidance for implementation suggests disclosing a range of related information, including the frequency and processes of informing management of climate-related activities and how the organization reacts at a managerial level to potential changes due to climate-related issues.

2. *Strategy*

The recommendations call for organizations to disclose the "actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material." Final Report at 20. The Task Force recommends disclosing descriptions of the specific climate-related risks and opportunities identified by the organization over the short, medium, and long-term that could have a "material financial impact" on the organization, and to include the internal processes used to evaluate such information. The Task Force also recommended disclosing the impact of climate-related risks and opportunities on the organization's businesses and strategy (such as supply chain issues, adaptation/mitigation activities, investment in research and development, and operations), as well as on the organization's financial planning process.

A third recommendation calls for organizations to use scenario analysis to inform strategic and financial planning, and to disclose how resilient the organization's strategies are under different climate scenarios. The Task Force recommends using a warming scenario of 2°C or lower above pre-industrial levels—the Paris Agreement target—as well as two or three other scenarios.

The Task Force envisions a robust scenario analysis that could require significant effort by businesses depending on the availability of data, particularly for those organizations operating across multiple jurisdictions and with various possible energy and technology pathways. The Task Force acknowledged that the existing work in this area is limited as applied to businesses and suggests different levels of effort dictated by the organization's exposure to climate-related risks and its experience with scenario analysis. In response to comments on the draft report that expectations around scenario analyses should be proportionate to the size of the organization to avoid being overly onerous, the Task Force set a threshold of one billion dollars in annual revenue above which it recommends that non-financial organizations should perform more rigorous scenario analyses and disclose additional information regarding the resiliency of their strategies. The Task Force provided further suggestions for performing and disclosing scenario analyses in Section D of the Final Report, which includes a discussion of the challenges and benefits as understood by the Task Force. See also the technical supplement on this topic linked to above.

3. *Risk Management*

The Task Force recommended disclosing the organization's processes for identifying and assessing climate-related risks, including how the organization determines the relative significance of climate-related risks in relation to other types of risk and the anticipated impacts of existing and emerging regulations, such as limits on emissions. Disclosing the processes the organization uses to manage these risks is also recommended, including how the organization prioritizes and makes decisions surrounding climate risk, how it determines materiality, and how climate-related risk is integrated into the organization's overall risk management.

4. *Metrics and Targets*

The Task Force's overarching recommendation is to "disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material." Final Report at 22. The Task Force recommends: 1) describing the metrics used to evaluate risks and opportunities in line with the organization's strategy and risk management processes, including climate-related risks associated with water, energy, land use, and waste management, where applicable; and 2) Scope 1 and 2 (and 3, if appropriate)[1] greenhouse gas (GHG) emissions and related risks, including the calculation/estimation methodologies and historical data for use in trend analysis. Additionally, the Task Force recommends that organizations should disclose the targets they use to manage climate-related risks and opportunities, and how they measure performance against those targets.

Materiality Standard

In many of the G20 countries, public companies have a legal obligation to disclose material information in their financial reports, including material climate-related information. The Task Force suggests determining materiality for climate-related issues "consistent with how they [organizations] should determine the materiality of other information included in their financial filings." Final Report at 33. The Task Force acknowledged concerns raised in comments on the draft report over disclosing information in annual financial filings that is not clearly tied to an assessment of materiality, but it maintains the position that disclosures related to Governance and Risk Management recommendations should be provided in annual financial filings as important context for investors. The Task Force also believes that for disclosures concerning Strategy and Metrics and Targets, organizations should provide information on climate-related risks when the information is deemed material. The recommendations go beyond this for those organizations that are in the four non-financial groups (i.e., energy; materials and buildings; transportation; and agriculture, food, and forest products) and that have more than a billion dollars in annual revenue. Because the exposure of these groups may be higher, the Task Force recommends disclosing climate-related risks in other reports even when the information is not considered material and not included in financial filings. Final Report at 34.

[1] Scope 1 emissions are direct emissions from GHG sources owned or controlled by the reporting organization. Scope 2 emissions are indirect GHG emissions that do not physically occur within the organization's reporting boundary and are instead caused by the organization's energy source, typically consumption of electricity. Scope 3 emissions are an organization's indirect emissions other than those covered in Scope 2 that occur as a result of its activities. Carbon Disclosure Project, *Technical Note: Glossary of Terms*.

Implications for Businesses

At the time the Final Report was released, more than 100 companies across a range of industries (including banking, technology, consumer goods, chemical, and energy) had signed a statement supporting the final recommendations. This reflects a general trend of increased investor interest in sustainability-related disclosures. For example, of the original (i.e., not form) comment letters submitted on the SEC concept release, two-thirds discussed sustainability disclosures, and more than 85 percent of these letters supported improved sustainability-related disclosure in SEC filings, according to a press release by the Sustainability Accounting Standards Board (SASB).

Given the Task Force's recommendation that climate-related financial disclosures should be included in annual financial filings, the chief financial officer or other corporate officers of an organization are more likely to be involved in the review process, should an organization adopt the standards. Corporate officers will need to closely review the elements contained in various company filings and reports to ensure consistency across reporting and compliance with existing, and potentially expanding, disclosure requirements.

The Task Force's recommendations are likely to play an important role in shaping the disclosure landscape—particularly in the context of investor expectations and evaluation of ESG performance. The recommendations are released at a time when institutional investors and large hedge funds are increasingly evaluating climate risk and non-financial reporting as part of their investment strategy, including as a proxy for corporate governance. Moreover, the information released or not released by companies is being increasingly scrutinized in the media and by third parties, including through new tools and public databases that make it easier to compare climate reporting across companies with little effort. U.S. companies should expect to see additional pressure from NGOs and investors for more climate disclosures from the private sector in the context of the Trump Administration's announced intent to withdraw from the Paris Agreement.

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