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Talking Points

The TCFD Recommendations and Their Implications for the Financial Sector

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The recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) look set to drive an increase in reporting of quantified, forward-looking ESG data and analysis. Trucost considers some of the main implications for the financial sector.

1. What is the TCFD and what are its recommendations?

The TCFD was formed by the Financial Stability Board, the international body that seeks to strengthen and protect markets from systemic threats such as climate change through its membership of national financial authorities. The TCFD recommendations provide guidance to all market participants on the disclosure of information on the financial implications of environmental risks and opportunities in annual reports and accounts to enable its integration into investment and business decisions (see Exhibit 1).[1]

The TCFD structured its recommendations around four core elements of the way in which organizations operate: governance, strategy, risk management, and metrics and targets (see Exhibit 2). The guidance applies to organizations in all sectors, with supplemental guidance for the financial sector including banks, insurance, asset managers and asset owners, and non-financial but potentially high-impact sectors including energy, transportation, materials and buildings, and agriculture, food and forestry.

Exhibit 1: The TCFD Recommendations

KEY FEATURES OF RECOMMENDATIONS
Adoptable by all organizations
Included in financial filings
Designed to solicit decision-useful, forward-looking information on financial impacts
Strong focus on risks and opportunities related to transition to lower-carbon economy

Source: Task Force on Climate-related Financial Disclosure, 2017. Table is provided for illustrative purposes.

[1] TCFD Final Report, *Recommendations of the Task Force on Climate-related Financial Disclosure*, 2017, available at https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf

Exhibit 2: Core Elements of Recommended Climate-Related Financial Disclosures

Governance
The organization's governance around climate-related risks and opportunities.

Strategy
The actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.

Risk Manangement
The process used by the organization to identify, assess, and manage climate-related risks.

Metrics
The metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Source: Task Force on Climate-related Financial Disclosure, 2017. Chart is provided for illustrative purposes.

One common misconception is that the TCFD recommendations are only concerned with carbon emissions. In fact, the recommendations clearly state that the financial performance of organizations may also be affected by other climate-related environmental issues, in particular water scarcity and water quality, and disclosure on these issues is included in the recommendations.

2. Why should organizations report in accordance with the TCFD recommendations?

Risk management is the main reason. Companies face a host of physical, regulatory and marketplace risks from climate-related environmental impacts which could affect their financial performance, their ability to repay loans or pay insurance premiums, and therefore potentially affecting their firm value with implications for shareholders, creditors, pension funds, banks, and insurers. It is therefore in the interest of all market participants to disclose data, and require data from their investee companies, on environmental risks. This will enable markets to price risk and support informed investment decisions.

Another important reason organizations should disclose under the TCFD recommendations is the potential business opportunities of the transition to a low-carbon economy. It is estimated that some USD 1 trillion per year of investments in low-carbon technology will be needed for the foreseeable future if we are to meet the Paris Agreement goals.[2] Companies creating products and services that enable this transition may be among the winners, while companies that persist with carbon-intensive activities could be among the losers. Financial institutions will want to ensure they can identify and profit from the winners.

3. What metrics should the financial sector disclose?

The TCFD recommendations are clear and comprehensive, but not prescriptive. They recognize that different types of organizations need different ranges of metrics that can be used in different applications. For example, while financial institutions should report their own operational emissions from offices and IT networks, the carbon emissions of their assets and investments are likely to be far more significant.

As a starting point, the main metric that the TCFD recommends asset owners should disclose is the weighted average carbon intensity of their portfolios expressed in metric tons of carbon dioxide equivalent (tCO2e) per million U.S. dollars revenue. The TCFD says asset owners can disclose other useful metrics such as the total carbon emissions of a portfolio normalized by its market value (or assets under management), expressed as tCO2e/USD million invested. Other options include the carbon efficiency of a portfolio measured as tCO2e/USD million revenue, or exposure to carbon-related assets as the amount or percentage of the current portfolio value.

The TCFD acknowledges the challenges of current carbon metrics—for instance, that they should not necessarily be interpreted as risk metrics. It views reporting of weighted average carbon intensity of a portfolio as a "first step" and expects that its disclosure will prompt important advancements in the development of decision-useful, climate-related risk metrics.

[2] International Energy Agency, *World Energy Outlook Special Briefing for COP21*, 2015, available at https://www.iea.org/media/news/WEO_INDC_Paper_Final_WEB.PDF

The TCFD's message for the financial sector is that the evolving nature of carbon footprinting should not be an excuse for doing nothing—they should learn by doing. Nor will the qualitative approach to disclosure of some organizations suffice. The market is demanding quantitative data that is robust, more standardized, and insightful to inform investment analysis and decision making.

4. What is scenario analysis and how should organizations do it?

One of the most important barriers to sustainable finance is the disconnect between the long-term problems posed by climate change, and the comparatively short-term focus on business strategies and performance of companies and financial institutions. Research by the 2° Investing Initiative found that most market participants only forecast financial performance up to five years ahead. In contrast, it could take 20 years or more for the most serious impacts of climate change on economies to develop—although the early signs are already clear and having damaging effects.[3] In his groundbreaking speech at Lloyds of London in 2015, Mark Carney, chair of the Financial Stability Board and governor of the Bank of England, called this issue the tragedy of the horizons, "Once climate change becomes a defining issue for financial stability", he said, "it may already be too late." [4]

To address this problem, the TCFD recommends that organizations use the well-known technique of scenario analysis within the context of climate change risks. Financial institutions can use scenario analysis to assess the performance of their investments and portfolios under a range of future physical, regulatory and market scenarios. Companies can stress test their business models to see how resilient they are likely to be in the transition to a low-carbon economy over a variety of time periods such as by 2020, 2030, or 2050.

Scenario analysis from a climate change perspective involves comparing an organization's strategy to a number of future climate-related scenarios, including one in which governments implement policies to limit the average global increase in temperature to two degrees Celsius, in accordance with country commitments made under the Paris Agreement.

Trucost calculates that average carbon prices could increase more than sevenfold from current prices to USD 120 per metric ton by 2030 as a result. Under other scenarios, the trajectory of carbon price increases might be different if policies are weak or delayed. To understand their exposure to rising carbon prices and inform scenario analysis, companies and financial institutions may find it useful to use a carbon pricing tool such as the **Carbon Pricing Investor Toolkit** and the **Corporate Carbon Pricing Tool**.

5. How can the financial sector use the insights from these metrics and analysis?

Aside from two-degree scenario analysis, there are a range of metrics and tools available to financial institutions. The choice of tool depends on their investment strategy and whether the information is for reporting purposes or for more forward-looking consideration. For example, if an asset manager wants to assess exposure to fossil fuel-based "stranded assets", an assessment of the exposure of a fund to fossil fuel reserves and the carbon emissions embedded within them is required. Another example of stranded assets includes energy inefficient real estate, which the owner is unable to rent. For asset owners that wish to disassociate or restrict their investments in coal, an assessment of the holding's coal mining and coal power generation activities is required. For many market participants, understanding a company's mix of "brown activities" and "green activities" is a core piece of information. To understand and communicate the positive green impact of a fund, a deeper assessment of the types of "green" activities is necessary, and ideally a robust quantification of the carbon savings or environmental benefit per USD million invested.

6. What practical steps should the financial sector take right now toward meeting the TCFD recommendations?

The TCFD says widespread adoption of its recommendations is critical. The Financial Stability Board has extended the TCFD's mandate until at least September 2018 so that it can monitor the uptake of the recommendations and evaluate whether disclosures

[3] 2 ° Investing Initiative, *All Swans are Black in the Dark: How the Short-term Focus of Financial Analysis does not Shed Light on Long-term Risks*, 2017, available at https://www.genfound.org/media/1383/all-swans-are-black-in-the-dark.pdf

[4] Mark Carney, *Breaking the Tragedy of the Horizon—Climate Change and Financial Stability, speech to Lloyds of London*, 2015, available at http://www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx

meet the needs of users. The EU High Level Expert Group on Sustainable Finance recommends that the TCFD recommendations be integrated into EU policy.[5] More than 100 companies with a combined market cap of around USD 3.5 trillion and financial institutions responsible for assets of about USD 25 trillion have stated their support for the TCFD recommendations following the launch in July 2017.[6]

The TCFD says asset owners have a crucial role to play in influencing better disclosure as they sit at the top of the investment chain. They can engage with companies to encourage disclosure in accordance with the TCFD recommendations. They can also require their asset managers to meet the recommendations. Asset owners can follow the TCFD recommendations themselves to show beneficiaries that they are meeting their fiduciary duty to consider climate-related risks and opportunities in investments decisions. Asset managers can follow the TCFD recommendations to demonstrate to asset owners that they take a responsible approach to investment.

Immediate practical steps that organizations in the financial sector can already take toward meeting the TCFD recommendations include:

- Measure and disclose the carbon footprint of your investments, using the weighted average carbon intensity, alongside other carbon efficiency assessments;
- Consider which other carbon metrics and analytical tools, both retrospective and prospective, may be appropriate for your investment strategy and reporting;
- Focus on each asset class as the risks and opportunities will vary and so will the most appropriate carbon metrics;
- Supplement footprint analysis with deep dives into key carbon-intensive sectors such as energy, transportation, materials, and food, agriculture and forestry;
- Conduct water footprinting to assess risks from sectors exposed to increasing water scarcity and pollution in their operations and supply chains; and
- Demonstrate that your organization is responding to the TCFD recommendations by disclosing progress in annual reports and financial filings.

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[5] HLEG Interim Report, *Financing a Sustainable European Economy*, 2017, available at https://ec.europa.eu/info/sites/info/files/170713-sustainable-finance-report_en.pdf

[6] TCFD Press Release, 29 June 2017, *Final Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) Help Companies Disclose Climate-related Risks and Opportunities Efficiently and Effectively*, available at https://www.fsb-tcfd.org/wp-content/uploads/2017/06/Press-Release-Final-TCFD-Recommendations-Report-Release-29-June-2017-FINAL-IMMEDIATE-RELEASE-UPDATED-SUPPORTERS-LINK.pdf