

Using TCFDs to manage climate risk: next steps for UK government, investors and businesses

October 2019

Summary for policy makers

The UK's Green Finance Strategy took an important step forward by setting the expectation that all listed companies and large asset owners should disclose their climate-related risks and opportunities in line with the TCFD recommendations by 2022. However, to ensure a level playing field, provide meaningful and comparable information for investors and improve decision making, TCFD aligned reporting should be made mandatory on a comply or explain basis by the early 2020s for all companies currently reporting to the Streamlined Energy and Carbon Reporting regime. These requirements could then be rolled out to smaller firms once best practice and meaningful reference scenarios have been established.

A key focus of TCFD aligned reporting should be to improve business and investor decision making. The implementation of this new reporting regime should include a requirement to report on how an entity is managing its risk.

Following the creation of the Climate Financial Risk Forum for financial firms, TCFD implementation should be supported by the establishment of a Corporate Reporting Lab focused on corporate organisations and coordinated by government, to enable the development of sector-level guidance on scenario analysis, encourage 'learning by doing' and reduce near-term reputational risk for early movers.

In implementing the TCFDs across UK market participants, the government should continue to engage closely with key international partners such as the EU to ensure as much consistency as possible on disclosure requirements.

BACKGROUND

The Financial Stability Board (FSB)'s industry-led Taskforce on Climate-related Financial Disclosure published its recommendations ('the TCFDs') in June 2017, recognising that climate change poses a systemic risk to the financial system and **calling on all companies to improve their disclosure of financial risks arising from climate change in mainstream financial filings.** The recommendations provide a voluntary framework to translate

sustainability information into financial terms, with the aim of soliciting decision-useful and forward-looking data.

The Aldersgate Group views the TCFDs as **an essential instrument to facilitate transparency in the financial markets and improve company-level decision making, by minimising physical and transition risks from climate change faced by businesses and investors.** A recent review of 7,000 firms found that companies face potential losses of \$970bn related to direct and indirect climate risks.¹

¹ CDP Global Climate Change Analysis 2018 <https://t.co/HgPtdv3r9o> [accessed 20 July 2019]

The 2018/19 reporting year is the second year where early-adopter businesses, banks and investors are trialling TCFD reporting. However, the TCFD's second status report in June 2019 found that **“not enough companies are disclosing decision-useful climate-related financial information”**.² To both increase the uptake of TCFD-aligned reporting, and to ensure it is not simply an exercise in greater volume of disclosure, but **actually leads to a meaningful change in business and investment strategies to reduce exposure to climate risk**, greater policy intervention will be required.

This briefing is based on significant industry engagement, including a recent Aldersgate Group roundtable which brought together corporate and financial sector representatives to discuss early learnings from TCFD implementation and to identify how policy could best support meaningful implementation of the TCFDs.³ It also builds on previous industry engagement on this topic. This briefing sets out some of the key challenges and learnings to date to produce six initial recommendations to government, businesses and investors.

Lessons from early implementation of TCFD reporting

- Implementation of forward-looking climate change risk disclosure is nascent for the majority of companies, many of which are just starting the process of understanding how best to go about it.
- There will be a ‘learning by doing’ process, and it will take companies three to five years to get comfortable with presenting the outputs of TCFDs in a way that is coherent and leads to better decision making.
- Any approach to modelling future risks has limitations. Many companies are currently using stochastic models, which can estimate the probability of potential outcomes, and basing scenarios on Representative Concentration Pathways from the Intergovernmental Panel on Climate Change, which still leaves a high degree of uncertainty around concentration thresholds and when subsequent impacts will be felt.
- Understanding the likely physical impacts at different degrees of temperature increase is key for modelling risk, but this needs to be accompanied by an understanding of the pathways that lead to different warming scenarios and comprehensive actions to mitigate the transition risks that might arise.
- For many companies, the greatest risks are in late and disorderly transition (regulatory / transition risk), or low probability but high impact (extreme) events (physical risk).
- What companies are saying in their public disclosures differs markedly from the conversations they are having behind closed doors.
- Current risk reporting is too focused on measurement and development of precise metrics, and not enough on using the data gathered to inform decision making to mitigate or manage those risks. This needs to be rectified as the ultimate goal of TCFD aligned reporting is to improve decision making.

² FSB-TCFD (June 2019) *TCFD: 2019 Status Report*

³ Recommendations made in this briefing cannot be attributed to any single organisation and the Aldersgate Group takes full responsibility for the views expressed.

THE CURRENT STATE OF PLAY

The UK was one of the first countries to formally endorse the TCFDs. The Green Finance Strategy released in July 2019 built on this, setting out the **government's expectation for all listed companies and large asset owners to disclose in line with the TCFD recommendations by 2022**. It also committed to establish a joint taskforce with UK regulators, chaired by government, to "examine the most effective way to approach disclosure, including exploring the appropriateness of mandatory reporting". The government will conduct an interim review of progress in 2020 to assess whether further action is required on TCFD implementation, and a formal review in 2022.

The government has further committed to supporting quality disclosures through data and guidance, such as that being prepared for occupational pension schemes by a new government and regulator-sponsored working group. In addition, it will consider its own climate-related financial risks as part of the 2020 Managing Financial Risks report, and through the Commonwealth Development Corporation (CDC) and UK Export Finance which will make TCFD-aligned disclosures "as soon as practicable, following the close of the 2020/21 financial year".⁴ Whilst not part of the TCFD recommendations, the Green Finance Strategy also set out an intention to work with international partners to catalyse market-led action on enhancing nature-related financial disclosures.

From a regulatory perspective, the Prudential Regulatory Authority has already set out an expectation that banks, insurers and regulated financial firms will introduce TCFD-aligned reporting and risk management via a Supervisory Statement in April 2019. It found that "while firms are enhancing their approaches to managing the financial risks from climate change, few firms are taking a strategic approach that considers how actions today affect future financial risks."⁵

At the European level, the EU has published non-binding guidelines integrating the TCFD recommendations into the Non-Financial Reporting Directive, which continues to apply to large listed companies, banks and insurers.

The regulatory drivers for climate risk reporting are therefore relatively strong in the UK. However, they stop short of making TCFD reporting mandatory. Many companies remain uncertain as to how to undertake sophisticated climate risk analysis, which in turn is affecting the risk data that financial firms have about their portfolios. **There is therefore a need at this juncture to explore how policy can increase uptake of TCFD aligned reporting on a voluntary basis initially and how making it mandatory in the medium term can improve reporting practice, improve decision making and be done in a way that TCFD-aligned reporting is as practicable and user-friendly as possible for companies.**

⁴ HM Government (July 2019) *Green Finance Strategy*

⁵ PRA (April 2019) Supervisory Statement SS3/19

RECOMMENDATIONS FOR GOVERNMENT, INVESTORS AND BUSINESSES

1. Reporting of climate change risk must ultimately be mandatory to provide more data and create a level playing field

Widespread and consistent reporting of climate risk is vital to establish a level playing field amongst companies and provide complete information for investors. As one financial services representative told us: “With all the best will in the world, we would not be doing this if the PRA hadn’t required us to.” Mandatory disclosure can also help close the gap between market players that are traditionally more focused on short-term risks and returns and those that by the very nature of their business have to consider long-term risks irrespective of reporting requirements. Furthermore, the more complete the data disclosed, the better businesses and investors can improve their resilience against climate-related risks. For example, the extent to which regulated financial firms complying with TCFDs understand risks is partly dependent on effective asset-level (i.e. investee or loan-holding company) disclosure. As such, **all market players must be regulated to respond to this challenge, rather than leaving leading firms to do so on a voluntary basis.** The 2019 Green Finance Strategy stopped short of making this mandatory, instead committing to review voluntary disclosure.

Mandatory disclosure is supported by industry. The Green Finance Taskforce recommended that TCFDs should ultimately be incorporated in UK legislation.⁶

Following an in-depth inquiry, the House of Commons Environmental Audit Committee has recommended that climate change risk and opportunity reporting should be mandatory by 2022.⁷ Aldersgate Group corporate members have found from their experience of Mandatory Carbon Reporting that the requirement for disclosure to be mandatory and signed off at board level has been a critical tool for boosting carbon literacy across companies, highlighting vulnerabilities to future risks and increasing the salience of opportunities to boost efficiency and productivity through energy saving or climate change mitigation measures.⁸

It may be strategic to take a staggered approach to introducing requirements on climate risk reporting, beginning with the largest firms and rolling out to smaller firms once best practice and meaningful reference scenarios have been established. However, **a clear direction of travel for all market participants to analyse and act on their climate risks will catalyse uptake and the development of useful supporting tools.** Rolling out disclosure requirements to smaller firms will also give a clearer picture of the resilience of the entire supply chain and highlight risks that could otherwise be overlooked if large companies are the only ones reporting and undergoing risk assessments.

⁶ Green Finance Taskforce (March 2018) *Accelerating Green Finance*

⁷ House of Commons Environmental Audit Committee (June 2018) *Greening Finance: embedding sustainability in financial decision making*

⁸ Previous submissions to government consultations available upon request.

Compliance with mandatory disclosure will need to be well-enforced to ensure that poor disclosure is not understood by stakeholders as a lack of risk, putting those companies who are transparent at a disadvantage.

It is worth noting that TCFD guidelines currently ask for climate risks to be reported only when they are assessed by the company to be a principal risk and source of uncertainty. To ensure a level playing field, policy needs to close this loophole by demanding companies taking this position to justify why they are not classifying climate-related risks as principal risks, in line with the comply or explain approach we discuss below.

Government can help to create ‘safe harbour’ provisions for those who report on climate risk and potentially expose themselves to more immediate challenges, by making it more risky for those who haven’t disclosed properly (i.e. through liability).

2. Government should require companies to disclose what actions they are taking to manage identified risk

As the government’s Green Finance Strategy points out, **“disclosure is only useful if it guides decision-making”**.⁹ However, early experience of TCFD reporting shows that disclosers tend to get caught up in trying to put precise metrics on risks, with insufficient focus on taking action to mitigate them.

Moreover, the inevitable limitations of modelling mean that trying to accurately predict risk can distract companies from managing it.

A clear linkage must be made between reporting and action. For example, the PRA sets out an expectation in its Supervisory Statement that firms must evidence how they will mitigate the identified financial risks and have a credible plan or policies in place for managing exposures. This should be incorporated into the government’s expectations for all large companies and asset owners: **reports should include information on the measures taken by firms to manage their identified climate risks**, and any assumptions used in scenario analysis.

One helpful approach to focus on risk management in the initial stages may be for companies to **identify broad risks and then boil these down to the two or three areas with the most significant impacts**, improving understanding over time. Companies can then analyse whether or not they are managing those risks appropriately. For example, a bank could consider whether its business customers are prepared for climate change, rather than undertaking modelling on precise temperature differences. This is aligned with the **current corporate approach to risks, which are often discussed in qualitative rather than quantitative terms**. For example, rather than asking consultants to model specific scenarios, clients are interested in understanding how to secure the value of the assets they have.

⁹ HM Government (July 2019) *Green Finance Strategy*

What we heard

If it doesn't result in a positive difference, what's the point?

The number itself is almost irrelevant. A perfect model gets us away from understanding and managing risk.

To be meaningful, financial risk from climate change must be incorporated into mainstream annual financial filings, presented under a specific risk category that clearly sets out the material and long-term regulatory and physical risks linked to climate change. This information must have board level accountability to ensure adequate strategic oversight. Corporate environment teams should work closely with their finance teams and C-suite executives in preparing TCFD-aligned reports to ensure that the data produced is then translated into appropriate decisions. Third party climate risk assessors then can be brought in to assess whether risk analysis approaches are appropriate and identify possible next steps. This could be incorporated into the annual assurance process that many large companies undertake.

3. Market participants must be encouraged to look far beyond usual business planning timelines

There is a mismatch between the stated intentions of the TCFDs, and what they can actually deliver given current business practice and modelling limitations. A major challenge is that investors and corporates alike tend to prioritise short-term risk in their decision making. For example, the retail sector uses standard viability statements with detailed risk considerations on a three-year time horizon.

In standard financial calculations, a discount rate is applied to future value, which also underplays the financial impact of future risks.

Getting climate change risk onto the risk register and seeing it as material, even with TCFDs, remains very challenging.

Climate modelling and analysis is not currently seen as sufficiently robust, so these risks cannot compete with other better quantified and more immediate risks. Moreover, there is a great deal of uncertainty: circumstances can change significantly between now and 2050, so the likelihood of those risks coming to fruition may seem remote from the perspective of the business planning process. To compound this, businesses and investors do not necessarily see climate change as a risk to the viability of any one institution – rather, it represents a substantial threat to the whole economic system, given the interdependence of big institutions.

To help address this, **disclosers should be required to explain and justify why they are not including longer-term material risks in reporting, or why they do not see them as material.** 'Comply or explain' is a well-recognised approach across existing voluntary and mandatory reporting requirements. This should prompt investors, accountants, auditors and other stakeholders to raise questions about why companies are not thinking more long-term. Once one or two businesses start to move the dial on longer-term thinking, other businesses will rebuild consensus around that.

4. A Corporate Reporting Lab should be established to develop impartial sectoral scenario guidance

Initial guidance from government on assumptions of a 1.5°C scenario (the stated goal of the Paris Agreement) and a 4°C scenario (the current trajectory of warming) would be valuable to help ensure comparability between companies at the initial stages of implementation. This may take the form of an **endorsement of IPCC scenarios and/or commissioning Committee on Climate Change analysis for a more granular view of different temperature increases in the UK context.** Guidance should include recommendations on looking at both physical and transition risks.

In addition, **sectoral-level guidance based on an agreed baseline is needed to get a comparable ‘value at risk’ number across companies in the same industry and create a level playing field.** To illustrate why this is valuable, the Prudential Regulatory Authority is asking banks to hold additional capital against identified climate risks, so a divergence of scenarios may become a competitive advantage (or disadvantage) and can lead to arbitrage.

However, it is important to remember at this early stage the need to balance improving data quality, transparency and comparability on the one hand with the need to foster innovation and allow for some flexibility in this developing space on the other hand.¹⁰

The appropriate author of sectoral guidance may vary by sector. Guidance needs to be built on the experience of industry, but scenarios must not be diluted by conflicts of interest. Government should establish a Corporate Reporting Lab to help industries pilot approaches and identify best practice, which can gather input from trade associations and industry while remaining independent in producing sectoral guidance. To some extent, this is already being taken on by cross-industry platforms: the Network for Greening the Financial System is developing scenarios for financial firms for example. Where progress is lagging and industries are less regulated however, a government-convened Lab can help give structure to conversations around appropriate scenarios and ensure a level of standardisation of approach across industries. These conversations should include all relevant stakeholders, including regulators, academics and NGOs to ensure guidance is appropriate and the methodology is robust. This should also integrate the outputs of the TCFD and the Climate Financial Risk Forum.¹¹

¹⁰ GFMA (June 2019) *Sustainable Finance Survey Report*

¹¹ <https://www.bankofengland.co.uk/news/2019/march/first-meeting-of-the-pra-and-fca-joint-climate-financial-risk-forum> [accessed 31 July 2019]

Corporate Reporting Lab and the Climate Financial Risk Forum

There must be a process for disclosers to trial different approaches to climate risk reporting without fear of reputational risk to identify how best to identify and disclose risks and scenarios. The Climate Financial Risk Forum, jointly set up in March 2019 by the Prudential Regulation Authority and Financial Conduct Authority to build capacity within the finance industry, serves this purpose for the financial sector as a suitable, non-penalising arena for identifying reference scenarios with industry engagement. The outcomes of the Forum may also be instructive beyond the financial sector, helping establish investor-relevant scenarios that non-financial firms can use as the basis for their own disclosures.

A similar structure would be helpful for corporate companies to identify their risks in parallel. First recommended by the HLEG on Sustainable Finance,¹² a Corporate Reporting Lab (which could potentially be housed within the GFI) would provide reporting entities with a private 'safe space' to learn by doing, support inter-industry collaboration and share best practice, free from the threat of liability or penalty by investors. This may also help to drive a step change in planning horizons across industries. In both bodies, outputs must be widely accessible to market participants and academia to ensure transparency and promote further research.

5. The UK must keep up with international trends on climate disclosure

There is a great deal of international momentum for TCFD-aligned reporting, including in the European Commission, where non-binding guidelines integrating the TCFD recommendations into the Non-Financial Reporting Directive have been published.¹³ It will be important for UK regulators to align closely with the European Commission (dependent on final EU Exit arrangements) as it considers a fuller review of the UK reporting landscape to support coherence and comparability, particularly for multinational firms present in both the EU and UK markets. Some thought must be given to clarifying regulatory requirements for UK branches of foreign financial firms.

6. Investors must make their voice heard and engage with companies

Investors have a responsibility to engage with individual disclosures and come back to investee companies to ask why risks are not being reported and/or managed. They should also call out box-ticking exercises in disclosure that do not actually lead to climate-related risks being adequately addressed. This will help to create a first mover advantage, ensuring companies who are managing risk responsibly are rewarded by the market.

¹² Aldersgate Group (October 2018) *Securing and financing clean growth for the EU*

¹³ European Commission (March 2018) *Sustainable Finance Action Plan*