

Reporting climate change risk

A step-by-step guide to implementing the Financial Stability Board Task Force Recommendations for disclosing climate change risk

Contents

The Financial Stability Board Task Force Recommendations	1
Overview of the Recommendations	4
Overview of the reports	5
Key highlights of the Task Force reports	6
Why organizations should act now	10
Benefits of adopting the Recommendations	11
Steps to implement the Recommendations	12
EY contacts	13

The Financial Stability Board Task Force Recommendations

The Task Force on Climate-related Financial Disclosures (also known as the “Task Force” or “TCFD”) was set up by the Financial Stability Board (FSB) in 2015.

In June 2017, a series of recommendations (Recommendations) was issued to address gaps in the information disclosed on the financial impact of climate risk across the investment chain.

Globally, investors and shareholders have raised concerns about the lack of forward-looking assessments of climate related issues, including information on how vulnerable organizations may be to climate risks and advice on how they could mitigate these vulnerabilities. For organizations, the absence of an internationally recognized framework for disclosure prevents them from deciding what information is reported and how it is presented.

In response, the FSB created the industry-led Task Force in 2015 to establish a set of recommendations for consistent “disclosures that will help financial market participants understand their climate risks.” Mark Carney, the Governor of the Bank of England and founder of the Task Force, echoed this by warning that the fight against climate change will likely be jeopardized unless the risks associated with climate change are priced into capital allocation. For this, investors need the right information to respond to these developments.

The aim of the Recommendations is for financial and nonfinancial sectors to take into account climate-related issues and to disclose the financial impact that climate risks have (or could have) on their organization. The Recommendations address a number of major challenges identified by the Task Force, including a lack of a coherent financial reporting framework, which makes it difficult for investors, creditors and underwriters to use existing disclosures in their financial decisions. These stakeholders may want to know which companies are most vulnerable to climate risk, which are best prepared, and which are taking action.

With the release of the Recommendations and associated sector-specific guidance in June 2017, organizations have the opportunity to apply a more rigorous and consistent approach to assessing and disclosing the financial impact of climate risks in their financial filings. All members of the Task Force have backed the disclosure recommendations. A group of over 140 policymakers from around the world signaled their support for the Recommendations, calling on all stock markets to ensure listed firms embrace the new guidance on climate risk disclosure.

This publication provides you with guidance to navigate the next steps towards managing your exposure to climate risks and addressing investors' and shareholders' expectations.

If you would like to continue the conversation, do not hesitate to get in touch.

Key takeaways

- ▶ The adoption of the Recommendations is voluntary
- ▶ Recommendations apply to the financial sector (e.g., banks, insurance companies, asset owners and asset managers)
- ▶ Recommendations also apply to some high-risk nonfinancial sectors (e.g., energy, transportation, material and buildings, agriculture, food and forest products)
- ▶ Climate risks include transition risks and physical risks
- ▶ Scenario analysis should be applied for assessing climate risks, including a 2°C climate change scenario based on short-term, medium-term and long-term scenario definitions
- ▶ Qualitative and quantitative information should be provided on an annual basis in financial filings



Overview of the Recommendations

The Recommendations are structured around four themes that reflect core elements of how organizations operate – governance, strategy, risk management, and metrics and targets.

Governance

How climate risks can be integrated into the business

Strategy

How climate risks can be incorporated into future business decisions

Risk management

The processes used to identify, assess and manage climate-related risks

Metrics

The metrics and targets used to assess and manage risks and opportunities

Each recommendation is supported by recommended climate-related disclosures. The Task Force has issued three reports:

1. Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures¹
2. Annex: Implementing the Recommendations of the TCFD²
Guidance for implementation of the Recommendations for all sectors and sector-specific guidance
3. Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-related Risks and Opportunities³

Overview of the reports

Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures:

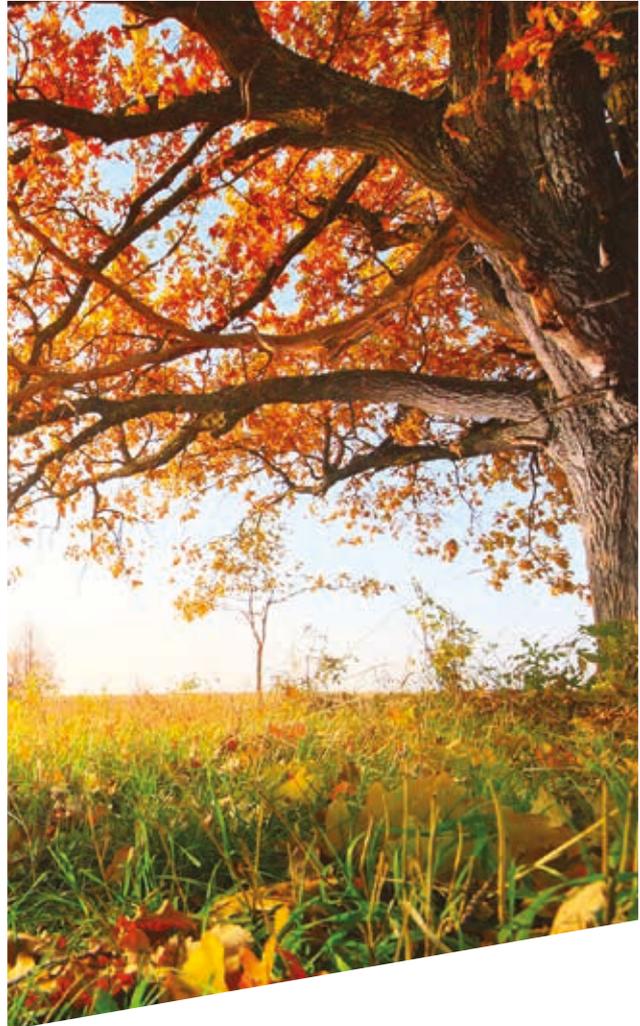
- ▶ Provides a description of the transition and physical risks and opportunities resulting from climate change
- ▶ Provides a description of the four themes structuring the Recommendations and examples of recommended disclosures
- ▶ Outlines the key issues considered by the Task Force and the areas requiring further work

Annex: Implementing the Recommendations of the TCFD:

- ▶ Provides suggestions of recommended disclosures for all sectors across the four areas
- ▶ Provides suggestions of sector-specific recommended disclosures for the financial sector and certain nonfinancial sectors potentially most affected by climate change

Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-related Risks and Opportunities:

- ▶ Provides guidance for applying scenario analysis for climate risks assessment and disclosures
- ▶ Provides examples of resources, tools, parameters and outputs
- ▶ Provides a description of different scenarios, including a 2°C scenario





Key highlights of the Task Force reports

Adoptable by all organizations

Because the transition to a low-carbon economy will affect most economic sectors and industries in some way, the Task Force outlines Recommendations on climate-related financial disclosures, which it describes as widely adoptable and applicable to organizations across all sectors and jurisdictions. The Task Force recommends all financial and nonfinancial organizations with public debt or equity (listed companies) implement its Recommendations, and also encourages other organizations to implement the Recommendations as well.

All organizations are recommended to provide information on their Scope 1 and Scope 2 greenhouse gas (GHG) emissions and, if appropriate, Scope 3 GHG emissions and the related risks.



Scope 3 refers to the emissions associated with the upstream and downstream life cycle of a product, process or service. Upstream activities include operations that relate to the initial stages of producing a good or service (e.g., material sourcing, material processing and supplier activities).

Downstream activities include operations that relate to processing the materials into a finished product and delivering it to the end user (e.g., transportation, distribution and consumption).

Included in financial filings

Climate-related financial disclosures should be included in mainstream financial filings, and should be subject to appropriate internal governance processes, similar to those used for existing public financial disclosures such as review by the chief financial officer and audit committee. Implementing the Recommendations will likely require company directors to engage with climate-related issues

more thoroughly. The Recommendations promote quantitative financial disclosures, particularly disclosure of metrics about the financial impact that climate-related risks have or could have on an organization (e.g., asset impairments, impact on cash flows from operations, net income and access to capital).

Designed to solicit decision useful, forward-looking information on financial impacts

The Task Force emphasizes a greater need for forward-looking analyses, highlighting climate change scenario analysis as being important for organizations to incorporate into their strategic and financial planning. The report recommends scenario analysis under different potential future states, including a 2°C scenario, in order to provide insights into how business strategy deals with climate change, especially for organizations operating or investing in carbon-intensive areas.

Technical supplement

The use of scenario analysis in disclosure of climate-related risks and opportunities.

Given the importance of forward-looking assessments of climate-related risk, a technical supplement is available to assist organizations in undertaking and using climate-related scenario analysis, including:

- ▶ Using scenario analysis
- ▶ Considerations for applying scenario analysis
- ▶ Analytical choices involved in scenario analysis
- ▶ Types of climate-related scenarios
- ▶ Publicly available climate-related scenarios from the International Energy Agency, the Intergovernmental Panel on Climate Change and others

Publicly available 2°C scenarios suggested by the report include:

- ▶ International Energy Agency, The 2°C Scenario (2DS)
- ▶ World Energy Outlook, 450 Scenario
- ▶ Deep Decarbonization Pathways Project

Scenario analysis may help provide better information for investors to assess how companies have aligned their technical business strategies with the requirements of the Paris Agreement. As outlined in the technical supplement, when performing the scenario analysis, organizations should ensure the following:

- ▶ That scenarios are appropriate and supporting assumptions are reasonable
- ▶ That relevant information is provided to board members and financial executives (e.g., chief financial officers, chief accounting officers and controllers), who should be involved in an organization's evaluation of climate-related risks and opportunities. This should also include information on the efforts undertaken to manage the risks and maximize the opportunities
- ▶ That links are between scenario analyses performed to assess the potential impact of climate-related risks, opportunities and assumptions underlying cash flow analyses used to assess assets (e.g., goodwill, intangibles and fixed assets) impairments

Strong focus on risks and opportunities related to transition to lower-carbon economy

The Task Force emphasizes the importance of integrating the identification and management of climate-related financial risk into existing risk management frameworks.

The report outlines specific categories for climate-related risks and climate-related opportunities in order to enable consistent categorization, divided into two major categories: risks related to the transition to a lower-carbon economy and risks related to the physical impacts of climate change (please refer to the diagram opposite). Transition risks include policy, legal, technology, reputational and market changes to address mitigation and adaptation requirements related to climate change. Climate-related opportunities include resource efficiency, energy source, products and services, markets and resilience.

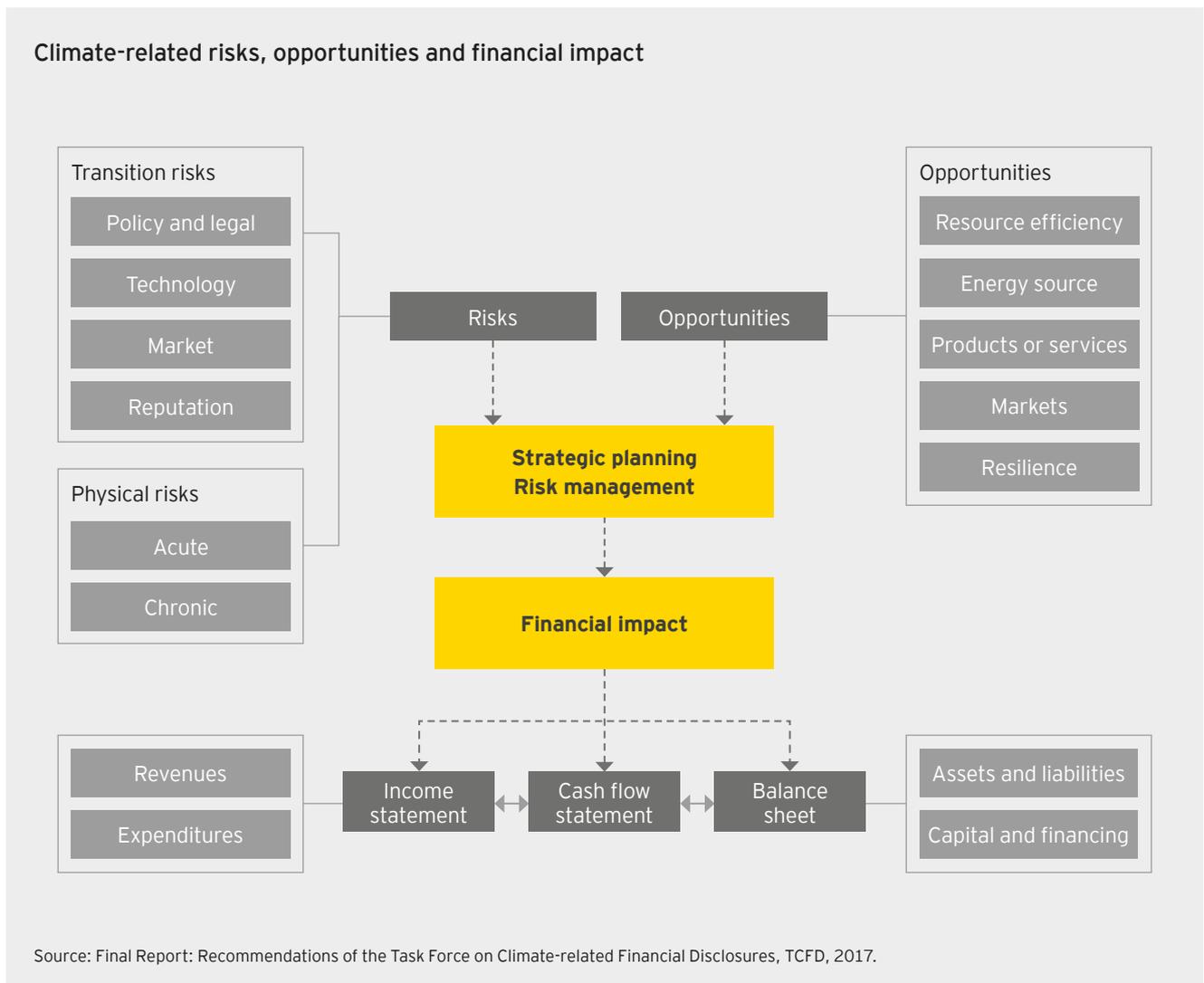
Disclosure of risk is recommended to be made for each time horizon (short, medium, and long-term) that could have a material financial impact on the organization.

Information quality controls

Because the climate risks disclosures should be included in mainstream financial reports or other public documents, the Task Force recommends that the governance processes should be similar to those used for existing public financial disclosures and would likely involve review by the chief financial officer and audit committee as appropriate.

For those organizations that do not have publicly traded debt or equity securities, including some asset managers and asset owners, the climate-related financial disclosures should follow similar review and approval protocols currently used by those organizations for similar communications. In cases where recommended disclosure is not made, preparers should provide their rationale for omitting the disclosure.

Disclosures should be defined, collected, recorded and analyzed in such a way that the information reported is verifiable to ensure it is of high quality. For future-oriented information, this means assumptions used can be traced back to their sources.





Why organizations should act now

Will your business take a “wait and see” approach or will it look to benefit from the adoption of the Recommendations?

Implementing the Recommendations may require changes to governance and risk assessment processes and may take several years for an organization to be in a position to generate valuable information for investors and shareholders to help them make informed decisions. The earlier your organization embarks on this journey the better, as it provides a platform to help educate directors and management about the climate risks and helps leadership to engage with investors and shareholders on the impacts and opportunities for your organization.

Benefits of adopting the Recommendations

As well as satisfying investors' demands there may be benefits for businesses who implement all of the Recommendations

Risk management

- ▶ Climate risks (transition risks and physical risks) are embedded in an organization's risk management process and risk register

Familiarization for scenario analysis

- ▶ Improved capability in quantitative modeling and data analytics
- ▶ Greater rigor and sophistication in the use of data sets and assumptions supporting the definition of scenarios

External communication

- ▶ Consistency of messaging across different external reporting mediums (e.g., investor relations, financial reporting, corporate reporting, sustainability reporting)

Shift the focus areas of external stakeholders

- ▶ Content of disclosures is more aligned with interest of long-term investors
- ▶ Focus of investors and shareholders shifts towards forward-looking assumptions and methodology, opportunities and strategy

Educational journey and fiduciary duty

- ▶ Increased directors' awareness of their fiduciary duty
- ▶ Education journey for board members and investor relations teams

Suggested steps to implement the Recommendations

Implementing the Recommendations may require organizations to collect new types of information and data from their supply chains and put in place new processes and governance structures. Integrating these changes into the business will take time and it is expected that many businesses will start on a journey to full implementation. Organizations should show investors that they are making progress and can start by adopting an implementation plan.

The table below sets out an optimistic timeline to reach full implementation

Year 1	Year 2	Year 3
<ul style="list-style-type: none"> ▶ Gap analysis of current disclosure state compared to the Recommendations ▶ Identification of new data and process requirements ▶ Collection of missing data and calculation of climate risk metrics from preliminary data set for internal benchmarking purposes and data quality control ▶ Review scenario analysis to identify a range of appropriate scenarios and apply them across the value chain to qualitatively assess impacted sectors for internal purposes ▶ Assign oversight to relevant board committees ▶ Disclosure of certain Recommendations dependent on current processes 	<ul style="list-style-type: none"> ▶ Implement new data and reporting processes ▶ Calculate climate metrics of full data set and compare to year 1 results. Set baseline metrics for external purposes and comparison in future years ▶ From year 1 scenario analysis, implement management strategies for any identified value chain risks ▶ Run scenario analysis using appropriate scenarios and identify qualitative risk areas and quantify potential impacts ▶ Document the process: communicate to relevant parties; be prepared to disclose key inputs, assumptions, analytical methods, outputs and potential management responses ▶ Disclosure of all Recommendations 	<ul style="list-style-type: none"> ▶ Integrate scenario analysis into strategic planning and/or enterprise risk management frameworks ▶ Ongoing implementation of Recommendations

EY contacts

So what now for organizations potentially impacted by climate change?

If you would like to discuss your next steps further, our multidisciplinary climate change team is ready to work with you.



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