Turning up *the heat on climate-related reporting*

Former Securities and Exchange Commission Chair Mary Schapiro and Unilever CFO Graeme Pitkethly are two key members of the Task Force on Climate-related Financial Disclosures. *Andy Davis* talks to them about reporting the effects of climate change, the need for a voluntary approach and how a new framework could help.

Awareness of the huge potential impacts of climate change has been spreading for at least 25 years. However, until recently, there has been no commonly accepted reporting framework that companies can use to make climate-related disclosures to their key stakeholders. Partly as a consequence, the degree to which they report on these issues varies considerably and, in many cases, disclosures are limited. The report from the Task Force on Climate-related Financial Disclosures (TCFD), published in December 2016, aims to change all that.

The Task Force was asked to do this work in late 2015 by the Bank of England Governor and Financial Stability Board Chair Mark Carney at the request of the G20 Finance Ministers and Central Bank Governors. Its 32 members were drawn from a wide variety of industries, as well as banks, asset owners, asset managers, ratings agencies, insurers and consultants. The aim was to create a broad, flexible framework that would meet the needs of both the companies making climate-related disclosures and their stakeholders.

Mary Schapiro (pictured on page 3), former Chair of the US Securities and Exchange

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Commission and a special adviser to Michael Bloomberg (who chairs the TCFD), argues that demand from investors, lenders and insurers for "decision-useful" climate-related financial information has reached a critical point.

The report sets out 11 recommended disclosures grouped under four headings – governance, strategy, risk management, and metrics and targets – that deliberately follow the approach companies use already for other types of disclosure (see panel, below). The TCFD also offers both general and sector-specific guidance for financial and nonfinancial companies.

RISKS AND OPPORTUNITIES

According to Schapiro, the proposed framework represents a single solution to three separate problems. First, businesses need a coherent reporting framework that is efficient and cost-effective. Second, asset owners, investors and financial intermediaries need concise, reliable information that allows meaningful comparisons between companies and enables better decision-making about capital allocation and the assumption of risk by lenders and underwriters. Finally, Schapiro says, regulators and policy-makers need a better view of "the risks that are building in the financial system stemming from climate-related impacts – and, frankly, the opportunities too, which is one of the novel things about the framework we've developed."

The intention is that the financial disclosures the TCFD calls for should form part of companies' mainstream financial filings, as this is where discussion of other material risks takes place. "Over time," says Graeme Pitkethly (pictured below), Vice-Chair of the TCFD and CFO of Unilever, "their adoption should promote better dialogue about material risks between companies and their stakeholders that leads to more accurate pricing of the business' securities. Ultimately, we're trying to

The main recommendations

Governance

Disclose the organization's governance around climate-related risks and opportunities.

Recommended disclosures:

- Describe the board's oversight of climate-related risks and opportunities
- Describe management's role in assessing and managing climate-related risks and opportunities

Strategy

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

Recommended disclosures:

- Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term
- Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy and financial planning
- Describe the potential impact of different scenarios, including a 2°C scenario (i.e., one where the rise in global temperatures following the industrial revolution is restricted to no more than 2°C), on the organization's businesses, strategy and financial planning

Risk management

Disclose how the organization identifies, assesses and manages climate-related risks.

Recommended disclosures:

- Describe the organization's processes for identifying and assessing climate-related risks
- Describe the organization's processes for managing climate-related risks
- Describe how processes for identifying, assessing and managing climate-related risks are integrated into the organization's overall risk management

Metrics and targets

Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities.

Recommended disclosures:

- Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process
- Disclose Scope 1 (direct), Scope 2 (energy indirect) and, if appropriate, Scope 3 (other indirect) greenhouse gas emissions and the related risks
- Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets

allow fair valuation and pricing that is appropriate to the level of risk and opportunity."

The Task Force held more than 120 individual meetings with interested parties and reviewed and catalogued the near-400 existing initiatives on climate-related impacts. It aimed to incorporate this huge body of previous work but, in doing so, to produce a set of recommendations with a different and very distinct focus. "Lots of frameworks focus on how companies impact the environment; we focused on how climate change and the environment impact companies from a financial standpoint," Schapiro explains. "That's an important differentiator."

The need to offer a clear path through the thicket of climate-related initiatives was also critical; faced with so many competing demands, it is easy for companies to "throw up their hands and say 'This is just too complicated'," says Schapiro. "These recommendations provide them with a coherent, informative framework for disclosure." Instead, companies that use the TCFD's recommended reporting framework can be confident that it synthesizes the existing work into a single source of guidance and best practice on climate-related financial reporting.

"We focused on how climate change and the environment impact companies from a financial standpoint."

Mary Schapiro

Scenario analysis

A central element of the TCFD's recommendations is that companies should consider using scenario analysis to support their strategic and financial planning, and that they should report the results and their proposed responses. It suggests that the base scenario should assume that the rise in global temperatures following the Industrial Revolution is restricted to no more than 2°C, but that a range of other scenarios "that covers a reasonable variety of future outcomes, both favorable and unfavorable" should also be planned and reported.

Scenario analysis is already commonly used in industries, such as energy and mining, which have significant exposure to climate-related impacts, but its use elsewhere is much more patchy. The TCFD acknowledges that, for many businesses, scenario analysis will be a more qualitative exercise than for many existing users, but argues that this does not render it irrelevant.

Graeme Pitkethly says Unilever does not currently use scenario analysis extensively, but adds: "What my time on the TCFD highlighted is the benefit of scenario analysis in helping businesses to think and talk internally about the impacts of climate change, both physical and transitional. I think we will start to use it in a more qualitative sense to help our internal decision-making and long-term strategic choices."

A FLEXIBLE FRAMEWORK

Pitkethly argues that the reporting framework had to be flexible rather than prescriptive because companies vary enormously across sectors and will therefore be affected very differently by the two major categories of climate-related risks the TCFD identified: the physical effects of climate-related events, and the risks (and opportunities) for their business of making the transition to a lower-carbon economy.

He believes Unilever, as a fast-moving consumer goods company with two billion customers each day in 190 countries, has more exposure to physical than to transition risk; but that, even so, most physical impacts do not have a great effect, because they are localized and Unilever's operations are dispersed so widely around the world.

However, its recent experience in Brazil has shown how exposed companies are to water scarcity. Brazil is a major market for Unilever's Omo laundry brand, and São Paulo, a city of 12 million people, has been hit by water shortages. "If people can't wash their clothes because there's no water, you get a sense of the impact – it goes into the tens of millions of euros," says Pitkethly. "These are climate-related risks and opportunities for businesses that are definitely material and that need to form part of our dialogue with stakeholders."

For companies in other, more carbon-intensive industries, such as energy or mining, the physical and transition risks are likely to be much more concentrated on particular locations and specific, major aspects of the way they operate. The TCFD's framework tries to accommodate these differences by taking a flexible and pragmatic approach to the job of setting out the reporting framework.

An important element of this flexibility is the TCFD's intention that companies should be able to use the framework as a starting point to develop their own approach to reporting on climate-related financial impacts, and that this should not involve excessive additional costs. The Task Force believes that the approach companies take will evolve from a more qualitative one at the beginning toward an increasingly quantitative set of disclosures as they develop their processes for climate-related reporting.

"While there will be some [additional] costs, these are largely costs that will be incurred in any event as companies meet their existing disclosure obligations. Investor demand for this information continues to grow," says Schapiro.

She also suggests that, as climate-related reporting becomes more mainstream, tools and analytical techniques will be developed that will help to reduce the compliance costs that companies face.

VOLUNTARY ADOPTION

Both Schapiro and Pitkethly acknowledge that the TCFD's framework has some overlaps with others, including the EU Directive on Non-Financial Reporting, which came into effect from January 2017, and the International Integrated Reporting Council's (IIRC) framework. However, there is little direct duplication, as both these initiatives are concerned with a wider set of issues than just climate-related financial impacts.

"I think many large companies will be well advanced in being ready to adopt the new requirements," says Pitkethly, "which shows that the market is already moving in the direction of more and better disclosure. My only concern is that companies should have the flexibility to report their own story in their own words, and I think the TCFD framework provides that."

Unlike the EU directive, though, the TCFD's framework is voluntary and will depend on its acceptance by companies to achieve widespread adoption. This was why the Task Force sought such a wide range of input from companies and financial intermediaries, Schapiro explains: "We knew our approach had to be practical and pragmatic for companies, because our goal is to have them adopt it without a regulatory mandate. As a result, business input was critical."

Pitkethly argues that compulsion would lead to "a proliferation of unhelpful, boilerplate disclosures" and that the voluntary approach is therefore best, although he acknowledges that this requires both "a push and a pull" for information; companies and their stakeholders alike need to understand the benefits of disclosure in promoting better dialogue and more efficient price discovery.

If companies choose not to engage because the framework is voluntary, he says, the solution will again be increased dialogue. The onus will be on stakeholders to ask: "Why do you believe you don't have material risks in this area?"

The TCFD began a 60-day consultation on its recommendations on 14 December 2016. The consultation period will be followed by a report back to the FSB, and the TCFD Recommendations report will be presented at the G20 Summit in July 2017.

So how will its success be judged? Schapiro believes this will become apparent over the coming year or two in the quantity and quality of disclosures of climate-related financial impacts that start to appear in companies' public filings. "It will be something that will evolve over time," she says. "But hopefully not a very long period of time." ■

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