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ESG Disclosures: Task Force on Climate-related Financial Disclosures

This client alert, part of a series focused on ESG disclosure and regulatory developments, summarizes the aims of the Task Force on Climate-related Financial Disclosures ("TCFD") and its disclosure recommendations. This alert should be read together with our ESG Lexicon, available here.

Key Takeaways

- *The TCFD recommendations, which consider the physical, liability and transition risks associated with climate change, are intended to facilitate the development of voluntary and consistent climate-related financial disclosures by companies for investors, lenders, insurers and other stakeholders.*
- *Since their publication in 2017, the TCFD recommendations have emerged as a leading international framework for climate-related disclosures, although uptake on these standards has been slower in the United States than elsewhere.*
- *The number of companies that reference the TCFD recommendations in their disclosures is steadily increasing, and industry leaders continue to call on companies to adopt these recommendations.*

Overview

The TCFD was established in December 2015 by the Financial Stability Board ("FSB") "to develop a set of voluntary, consistent disclosure recommendations for use by companies in providing information to investors, lenders and insurance underwriters about their climate-related financial risks."[1] Since their publication in 2017, the TCFD's final recommendations have emerged as a leading international framework for climate-related disclosures. According to one recent study, approximately two thirds of FTSE 100 companies referenced TCFD in their 2019 annual reports, an increase from 39% in 2018.[2] These numbers are likely to increase, as indicated by a recent CDP campaign of a "$10 trillion coalition of more than 100 global investors from 23 markets around the world . . . urging more than 1,000 companies with the highest environmental impact" to disclose data with TCFD-aligned standards.[3]

The Context

In 2015, the G20 asked the FSB to develop a framework for consistent climate-related financial risk disclosures for use by companies, insurance companies and investors. The G20 undertook this initiative in recognition of the growing imperative to ensure that the global financial system is resilient to emerging

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climate-related risk. The FSB launched the TCFD later that year to develop recommendations on climate-related financial disclosures. The TCFD, chaired by Michael Bloomberg, published its final recommendations report in June 2017.[4]

The TCFD recommendations are designed to solicit voluntary "decision-useful disclosures that enable [lenders, insurers and investors] to understand the impact of climate change on organizations."[5] The recommendations encourage companies to tie sustainability considerations to assessments of financial implications through scenario analyses that test how resilient corporate strategies might be in the context of possible climate change scenarios, including a 2°C or lower scenario. Scenario analysis is a "method for developing strategic plans that are more flexible or robust to a range of plausible future states."[6] Scenario analysis supplements disclosure of historical details through forward-looking assessments of climate change. In the words of the FSB, "[d]isclosure of climate-related financial information is a prerequisite for financial firms not only to manage and price climate risks appropriately but also, if they wish, to take lending, investment or insurance underwriting decisions based on their view of transition scenarios."[7] To date, scenario analyses remain the most difficult of the TCFD recommendations to apply, in part because there is no standardized framework for scenario analyses, although an increasing number of implementation guides and similar tools are available.[8]

Despite efforts over the past decade to encourage public companies to report on the steps they are taking to reduce greenhouse gas ("GHG") emissions and their carbon footprint, and the related impact on their financial statements and operations, the TCFD noted in its 2019 status report that disclosures generally fell short of the scale financial markets need to channel investments to sustainable and resilient solutions, opportunities and business models.[9] In February 2020, however, the TCFD announced that it had signed up more than 1,000 supporters of its recommendations, noting that this take-up signified "a major shift among market participants in acknowledging that climate change presents a financial risk."[10]

There are a number of significant market participants that are firmly aligned with the TCFD. In his 2020 "Dear CEO" letter, Blackrock CEO Larry Fink announced a series of initiatives to place sustainability at the center of Blackrock's investment approach.[11] Fink issued a call to arms for capital to be allocated to companies with sustainable business models, and argued that investors, regulators and insurers need a clearer way to measure how companies are "managing sustainability-related questions." Fink endorsed the TCFD framework for evaluating and reporting climate-related risks, as well as the related governance issues that are essential to managing them.[12] As noted above, a 2020 CDP campaign has also endorsed the TCFD recommendations.

The TCFD Framework

The TCFD recommendations target climate-related risks only (as opposed to other reporting initiatives that focus on sustainability and carbon reduction). The TCFD developed seven principles for effective disclosure: disclosures should represent relevant information; be specific and complete; be clear, balanced and

understandable; be consistent over time; be comparable among companies within a sector, industry or portfolio; be reliable, verifiable and objective; and be provided on a timely basis.

The disclosure recommendations fall into four thematic categories: governance; strategy; risk management; and metrics and targets. As shown in Annex A, the TCFD has identified supporting recommended disclosures and has provided guidance as to what type of information should be disclosed or considered for each recommendation. The TCFD believes that its recommended governance and risk management disclosures invariably will need to be included in annual reports, while its recommended strategy as well as metrics and targets disclosures should be addressed to the extent the organization deems them material.[13]

The TCFD also provided supplemental guidance to financial services groups as well as non-financial groups that account for the largest proportion of GHG emissions, water usage and energy usage.

Placing the TCFD Recommendations into Context

The TCFD recommendations should be viewed in the context of the broader disclosure landscape that has many moving pieces and differing views about which type of regime should govern climate risk disclosures. That this is a global topic involving different regulatory jurisdictions and different disclosure cultures adds to the complexity. The moving pieces represent any number of stakeholders – investors, insurance companies, public companies, NGOs, standard setters and regulators. As for trying to reach a consensus on disclosure regimes, the fault line divides those that favor line-item disclosure requirements from those that believe disclosure requirements should be principles-based, the bedrock of which is materiality. One very recent example of that fault line can be seen in the reactions to amendments to SEC disclosure rules that were announced in late August; two of the five SEC Commissioners voted against the disclosure amendments on the grounds that the amendments were silent on diversity and climate risk, and in the case of climate risk failed to even consider requiring more prescriptive climate risk disclosures.[14] Other Commissioners have warned of the dangers of moving away from a pure materiality standard.

As for the recommendations themselves, there are challenges, starting with the potential difficulty of moving climate-related disclosures from sustainability reports to annual reports (also known as integration of climate-related information into mainstream reports). A second challenge may be in collecting the information contemplated by the TCFD recommendations. Another criticism of the TCFD regime revolves around scenario analyses to assess how resilient corporate strategies are to climate-related risks and opportunities, and in particular, the difficulty in establishing the proper assumptions and the absence of standardized metrics. In its 2019 status report, the TCFD noted that companies adopting TCFD recommendations found scenario analysis to be one of the most challenging to implement. Finally, materiality, even in the context of line item requirements, remains a contentious issue. The TCFD noted in its final recommendations that “the financial impacts of climate-related issues are not always clear” and that “identifying the issues, assessing potential impacts and ensuring material issues are reflected in

financial filings may be challenging." Materiality determinations are complicated by variable metrics, targets and timescales and the fact that climate risks will differ depending on the stakeholder.

Looking Ahead

The TCFD recommendations are widely recognized as authoritative guidance for reporting climate-related information, and they remain voluntary. The TCFD, as we have noted in some of our other ESG alerts, is not alone in providing global climate-related disclosure standards. An increasing number of governments and regulators outside the United States have expressed support for global disclosure standards and are considering how to integrate them in guidance and policy frameworks. The number of asset managers incorporating TCFD or other standards in their investment guidelines also continues to grow. At the same time, there are calls for mandatory ESG disclosure requirements. While, in the United States, the SEC has not shifted its approach to climate-related (and broader ESG) disclosures, the trend is clear: ESG themes will continue to grow in prominence, and public companies will need to devote more time, effort and other resources to disclosure and governance around these topics. The TCFD recommendations, even if not embraced as the sole template for climate-related disclosures, do provide a useful starting point for thinking about the climate-related disclosure landscape.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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Annex A

TCFD Recommendations and Guidance for All Sectors

Topic	Recommended Disclosure	Guidance
Governance *Disclose the organization's governance around climate-related risks and opportunities*	The board's oversight of climate-related risk and opportunities	• The processes and frequency for informing the board and/or committees about climate-related issues • Whether the board and/or board committees consider these issues when reviewing and guiding strategy, major plans of action, risk management policies, budgets and business plans, as well performance targets and capital expenditures and acquisitions/dispositions
	Management's role in assessing and managing climate-related risks and opportunities	• Whether the organization has assigned climate-related responsibilities to management-level positions or committees and how it defines such responsibilities • How information regarding climate-related issues is delivered to and monitored by management
Strategy *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*	The climate-related risks and opportunities the organization has identified over the short, medium and long term	• The relevant time horizons, taking into consideration the useful life of the organization's assets or infrastructure and the fact that climate-related issues often manifest themselves over the medium and longer terms • The specific climate-related issues potentially arising in each time horizon that could have a material financial impact on the organization • A description of the process(es) used to determine which risks and opportunities could have a material financial impact on the organization
	The impact of climate-related risks and opportunities on the organization's businesses, strategy and financial planning	• How identified climate-related issues have affected businesses, strategy and financial planning • The impact on businesses and strategy regarding products and services, supply chain and/or value chain, adaptation and mitigation activities, investment in research and development and operations • How climate-related issues serve as an input to financial planning processes, the time periods that are used, and how these risks and opportunities are

		prioritized; the interdependencies that affect long-term value • The impact on financial planning of the following areas: operations costs and revenues, capital expenditures and capital allocation, acquisitions or divestments, and access to capital
	The resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario	• Forward-looking analysis of the resilience of the organization's strategy, taking into consideration a transition to a lower-carbon economy consistent with a 2°C or lower scenario and, where relevant to the organization, scenarios consistent with increased physical climate-related risks.
Risk Management *Disclose how the organization identifies, assesses and manages climate-related risks*	The organization's processes for identifying and assessing climate-related risks	• How the organization determines the relative significance of climate-related risks in relation to other risks • Whether the organization considers existing and emerging regulatory requirements related to climate change (such as limits on emissions) • Whether the organization considers processes for assessing the potential size and scope of identified climate-related risks and definitions of risk terminology used or references to existing risk classification frameworks used
	The organization's processes for managing climate-related risks	• How the organization makes decisions to mitigate, transfer, accept or control and prioritize climate-related risks, including how materiality determinations are made
	How processes for identifying, assessing and managing climate-related risks are integrated into the organization's overall risk management	• 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*	The metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process	• Whether and how related performance metrics are incorporated into remuneration policies • Internal carbon prices as well as climate-related opportunity metrics, such as revenue from products and services designed for a lower-carbon economy

assess and manage relevant climate-related risks and opportunities where such information is material	Scope 1, Scope 2, and, if appropriate, Scope 3 GHG emissions, and the related risks	• GHG emissions should be calculated in line with the GHG Protocol methodology to allow for aggregation and comparability across organizations and jurisdictions
	The targets used by the organization to manage climate-related risks and opportunities and performance against targets	• Whether the organization's key climate-related targets such as those related to GHG emissions, water usage, energy usage, etc., are in line with anticipated regulatory requirements or market constraints or other goals

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[1] Financial Stability Board, Press Release, "TCFD report finds encouraging progress on climate-related financial disclosure, but also need for further progress to consider financial risks" (June 5, 2019), available here.

[2] Tim Human, "Two thirds of FTSE 100 mention TCFD in reporting, finds research," *Investor Relations Magazine* (June 17, 2020), available here.

[3] Mike Scott, "Investors Step Up Pressure On Companies That Don't Disclose Environmental Risks," *Forbes* (June 9, 2020), available here (describing the recent Non-Disclosure Campaign organized by CDP, the non-profit global environmental disclosure platform). CDP was formerly known as the Carbon Disclosure Project.

[4] *See* TCFD, "Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures" (June 2017), available here.

[5] *Id.*

[6] *Id. See also* TCFD "Technical Supplement: The Use of Scenario Analysis" (2017), available here. The TCFD notes that "[fo]r many organizations, the most significant effects of climate change are likely to emerge over the medium to longer term, but their precise timing and magnitude are uncertain. . . . To appropriately incorporate the potential effects of climate change into their planning processes, organizations need to consider how climate-related risks and opportunities may evolve and their potential business implications under different conditions. One way to assess such implications is through the use of scenario analysis." The TCFD describes scenario analysis as a process for identifying and assessing the potential implications of a range of plausible future states under conditions of uncertainty. Scenarios are hypothetical constructs and are not designed to deliver precise outcomes or forecasts. In effect, they provide a framework for considering how the future might look if certain trends continue or certain conditions are met, and in the case of climate-related risks facilitate an understanding of how various combinations of transition and physical risks may affect operations, strategies and financial performance over time. The analysis can be quantitative or qualitative.

[7] Financial Stability Board, "Climate-related Financial Disclosures," available here. Transition scenarios explore different pathways to deliver a given limit to global warming (*i.e.*, the changes in socio-economic systems compatible with limiting the global temperature rise).

[8] *See, e.g.*, "TCFD Implementation Guide: Using SASB Standards and the CDSB Framework to Enhance Climate-Related Financial Disclosures in Mainstream Reporting" issued by the Climate Disclosure Standards Board and the Sustainability Accounting Standards Board (2019), available here.

[9] *See* TCFD, "Task Force on Climate-related Financial Disclosures: 2019 Status Report," available here. *See also* TCFD, "Implementing the Recommendations of the Task Force on Climate-Related Financial Disclosures" (2017), available here.

[10] *See* TCFD press release, "More than 1,000 Global Organizations Declare Support for the Task Force on Climate-related Financial Disclosures and its Recommendations" (February 12, 2020), available here. ("Given the speed at which changes are needed to limit the rise in the global average temperature – across a wide range of sectors – more companies need to consider the potential impact of climate change and disclose material findings.") Approximately 200 of these organizations are headquartered in the United States.

[11] Larry Fink, Blackrock, "'Dear CEO' Letter" (2020), available here.

[12] Fink also endorsed The Sustainability Accounting Standards Board standards for reporting sustainability information across a wide range of issues, from labor practices to data privacy to business ethics.

[13] TCFD, "Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures."

[14] *See* our alert entitled "SEC Amends Disclosure Requirements for Business Sections, Legal Proceedings and Risk Factors," available here.