TCFD: Tie board & management compensation to climate goals + 6 more new metrics

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Recommendations made by the Task Force on Climate-related Financial Disclosures (TCFD) and its eleven climate-related financial disclosures (the Recommended Disclosures) are quickly becoming the globally accepted framework for reporting climate-related financial risks and opportunities.

On October 14, the TCFD released updated guidance (the Guidance) regarding Metrics & Targets and transition plans. In this article we review the Guidance, and introduce the TCFD reporting framework (the TCFD Framework) to those who may not be familiar with it.

New guidance for Metrics & Targets, transition plans

The TCFD identifies two categories of climate-related metrics (Climate Metrics): cross industry and industry specific. The Guidance identifies seven categories of cross-industry Climate Metrics that are derived from the 11 Recommended Disclosures. All firms (organizations, companies or other entities) should disclose these revised and new Climate Metrics as soon as possible. The Climate Metrics are as follows:

GHG emissions (MT of CO2e)	Absolute Scope 1, 2 and Scope 3 emissions, as well as emissions intensity
Transition risks (amount or %)	Amount and extent of assets or business activities vulnerable to transition risks
Physical risks (amount or %)	Amount and extent of assets or business activities vulnerable to physical risks
Climate-related opportunities (amount or %)	Proportion of revenue, assets, or other business activities aligned with climate-related opportunities
Capital deployment (reporting currency)	Amount of capital expenditure, financing or investment deployed toward climate-related risks and opportunities

Internal carbon price (price in reporting currency/MT CO2e)	Internal price on each tonne of GHG emissions used
Remuneration (%, weighting, description, or amount in reporting currency)	Proportion of executive management remuneration linked to climate considerations

The Guidance provides examples and explanations as to how the new Climate Metrics should be applied and recommends disclosure of Climate Metrics for current, historical and forward-looking periods. Furthermore, while the TCFD Framework states that disclosures related to Strategy and Metrics & Targets only need to be disclosed to the extent they are material, the Guidance is clear that absolute Scope 1 and Scope 2 emissions should be disclosed independent of a materiality assessment. While the disclosure of Scope 3 emissions is subject to materiality, the Guidance encourages firms to disclose such emissions. Indeed, many of the world's largest companies are already doing so.

The Climate Metrics are meant to be quantitative, not qualitative. The TCFD acknowledges that not all firms will have the resources to present quantitative information across all Climate Metrics. However, the Guidance "encourages organizations to begin where resources and expertise allow."

In addition to the Guidance, the TCFD also released an updated 2021 annex that provides further details and examples as to how the Climate Metrics should be calculated and reported. The 2021 annex replaces the 2017 annex.

Why TCFD, why now?

As a director or executive, if the TCFD is not something you are familiar with, it may be on your shortlist of things to accomplish before the year is out, and perhaps before COP26, the UN Climate Change Conference, wraps up on November 12.

By way of background, the TCFD is the global task force established by the Financial Stability Board in 2015 to develop a disclosure framework for climate-related risks and opportunities and how these tie into a company's financial future. In 2017 the TCFD released four recommendations and eleven Recommended Disclosures, which, together with the technical supplements and other guidance, comprise the TCFD Framework.

Since then, the TCFD Framework has steadily gained international support as the global framework for climate change related disclosure. The TCFD Framework has gained popularity among investors, insurers, pension funds and asset managers because it is one of the first climate change reporting frameworks to provide guidance on how to convert climate change risk and opportunities into reportable financial metrics.

Originally construed to be "by the market, for the market" and specifically applicable to the financial sector, government and the private and public sectors across all sectors of the economy are using the TCFD Framework. In addition to releasing the Guidance on October 14, the TCFD released three additional new documents, including the 2021 Status Report.

The Status Report showcases the global momentum behind adoption of the TCFD Framework. For the first time, more than 50 per cent of companies reviewed disclosed their climate-related risks and opportunities. The growth in the private sector was matched by governments, with several jurisdictions, including the G7 and the G20 finance ministers, putting their weight behind TCFD.

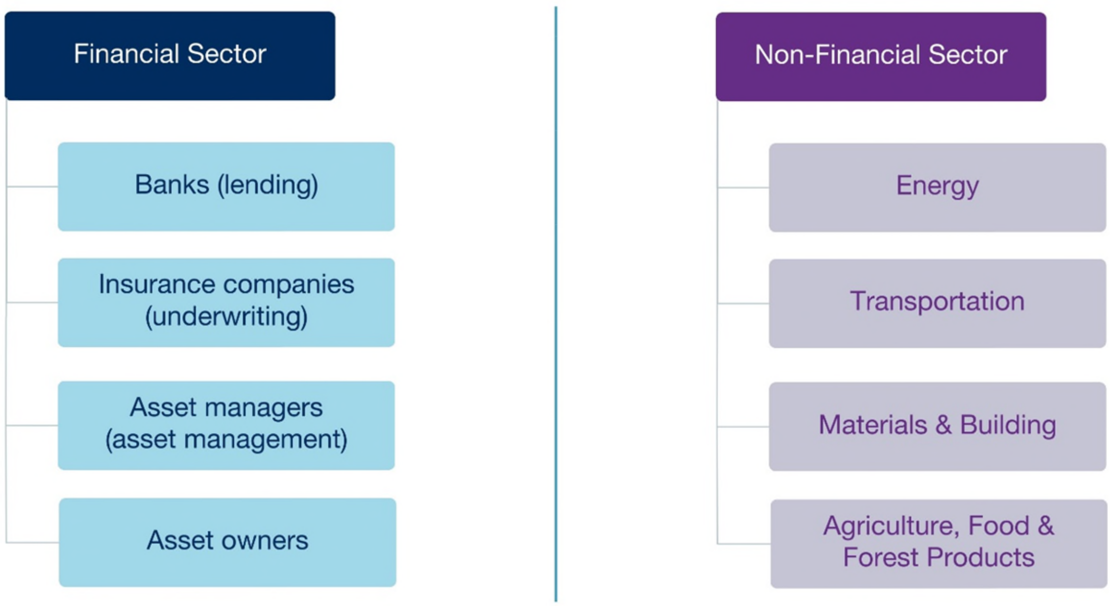
Various climate change and GHG reporting standards and frameworks have been in place since the early 2000s. As time went on and these standards grew in number, it became impossible to compare companies when it came to climate risk. The TCFD Framework is the answer to that, so far. Read our article on North America's shifting climate change landscape for more.

TCFD overview

The TCFD Framework is structured with four widely adoptable recommendations, each tied to a pillar:

1. Governance: Describe the organization's governance around climate-related risk and opportunities.
2. Strategy: Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's business, strategy, and financial planning where such information is material.
3. Risk Management: Disclose how the organization identifies, assesses and manages climate-related risks.
4. Metrics & Targets: Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

The Recommended Disclosures are made under each of the four recommendations. In addition to the recommendations and Recommended Disclosures, the TCFD has published guidance for all sectors and further specific guidance for both the financial and certain key non-financial industries, which are potentially most affected by climate change. The two main groups are further subdivided for the purposes of providing sector-specific guidance.



Asset owners include public- and private-sector pension plans, endowments and foundations (investing). Energy includes coal, oil & gas and utilities. Transportation includes air, rail and maritime. Materials & buildings includes metals, chemicals, mining, construction materials, capital goods and real estate. Agriculture et al. includes beverages, agriculture, packaged foods and meats, and forest products.

The TCFD secret sauce

The TCFD Framework brings three revolutionary aspects to climate change reporting:

1. focus on governance;
2. the use of scenario analysis; and
3. focus on transition risk.

Although still a work in progress, the TCFD's end objective is to use the Recommended Disclosures to convert climate risks and opportunities into reportable, quantitative metrics. This is a significant departure from most disclosure around climate change and its potential effects on businesses. These have predominantly been qualitative thus far, with the exception of GHG emissions.

Governance & annual public filings

The Recommended Disclosures under the Governance pillar apply specifically to the board and management. The TCFD Framework incorporates disclosure of climate-related risks and opportunities into mainstream (i.e., public) annual filings – documents and information that the board, management and, in some cases, auditors, oversee and sign off on.

Though only two of the Recommended Disclosures fall under the Governance pillar, the entirety of TCFD-aligned reporting is meant to be done via the annual reports. It is, therefore, implied that the board and senior management have oversight and direction of all Recommended Disclosures. The Risk Management and Strategy pillars are also areas that typically fall under the purview of the board and the C-suite.

Importantly, the TCFD Framework states that the Recommended Disclosures should only be made in a separate sustainability or ESG report in the event the firm does not have annual public filings. The message to boards is this: climate change is a significant non-diversifiable risk that has to be assessed and reported on consistently, transparently and in the same manner other material risks and opportunities present themselves. Climate change is material and it is material now.

Scenario analysis

Although many firms are already experiencing the adverse effects of climate change (for example, PG&E, California's largest electric utility, had to file for bankruptcy after a series of forest fires), the severity of climate change will increasingly be felt in the medium- and long-term, hence the use of scenario analysis.

Scenario analysis involves assessing potential business implications of climate-related risks and opportunities under hypothetical constructs. Scenario analysis is not designed to provide forecasts or precise outcomes.

The hypothetical constructs should cover the two categories of risk the TCFD Framework identifies, Transition and Physical. The Recommended Disclosures include describing the resilience of the firm's strategy, taking into consideration a 2C or lower warming scenario. In other words, what are the firm's climate-related risks and opportunities in a future in which the world seeks to keep global warming below 2 C, in alignment with the Paris Agreement.

By way of additional guidance, the TCFD recommends that firms select a set of scenarios that cover a reasonable variety of relevant future outcomes. Scenario analysis will likely be qualitative in the beginning. As firms gather more data and develop an expertise in TCFD-aligned reporting, it will trend towards quantitative reporting.

Scenario analysis can be a highly technical exercise – the TCFD has published a technical supplement dealing exclusively with scenario analysis – and inevitably involves the publication of forward-looking information.

Transition risk

The TCFD describes a transition plan as “an aspect of an organization’s overall business strategy that lays out a set of targets and actions supporting its transition toward a low-carbon economy, including actions such as reducing its GHG emissions.”

Transition plans are a natural outcome of setting climate targets (which are associated with metrics) and establish the pathway to achieving such targets, taking into account the specifics of the firm’s operations and mandates. Transition plans provide key information that allows investors to assess the credibility of the company’s commitments to climate change. The plan should be viewed as part of a firm’s climate strategy, which itself is part of a firm’s overall business strategy.

The Guidance provides additional detail on the aspects of an effective transition plan, which include:

1. It must be aligned with the firm’s broader strategy for addressing climate-related risks and opportunities.
2. It must have quantitative components, including the Climate Metrics and associated targets.
3. It should describe the internal approval and oversight process the plan is subject to, and ensure the plan is periodically reviewed and updated.
4. The plan should be reported annually to stakeholders.
5. It should contain actionable, specific initiatives, including regular milestones.

The more reliable information the plan contains, including limitations and constraints, the more credible the plan will be to those assessing it.

Conclusion

The TCFD Framework brings a new level of reporting to firms, helping them prepare for the risks and opportunities posed by climate change. If not done correctly, this can pose risks to the firms making the disclosure.

BLG’s Climate Change experts has partnered with climate and engineering consultancies to provide expert advice in this area. As a company moves toward increased climate transparency, our experts can ensure that it is protected while meeting the expectations of investors and regulators.

Reach out to any of the key contacts below if you have further questions about the TCFD recommendations.

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