WHITE PAPER | CLIMATE-RISK DISCLOSURE

Preparing for Climate-Risk Disclosure: Practical Suggestions for Public Companies

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Government task forces suffer from a bad reputation. Stuffed with members who have big titles but little appetite for hard work, such groups often are formed to bury an issue, not promote it.

But the Task Force on Climate-Related Financial Disclosures (TCFD) is an exception. Its report, issued June 29, is substantive and serious. It's likely to have a significant impact in boardrooms and investment committees.

Companies' environmental disclosures will need to become broader, deeper and more concrete.

Practical guidance for climate-related disclosures

The TCFD was established at the request of G20 finance ministers and central bank governors, led by Bank of England Governor Mark Carney, and was chaired by Michael Bloomberg. The goal was to develop recommendations that would create a "voluntary, consistent disclosure framework" to make climate-related financial disclosure easier to produce and use.

The lack of such a framework until now has made it difficult for issuers to meet their legal obligation to disclose material information and presented challenges for investors, lenders and insurers who need this information to price and allocate capital efficiently.

The task force lays out four thematic areas, reflecting the fundamental elements of an organization's structure, that climate disclosures should cover: governance, strategy, risk management and metrics, and targets.

The recommendations turn typical environmental reporting on its head by urging companies to assess the effect of climate change on the company instead of describing the impact of the organization's practices on the environment, which is now the common approach.

GOVERNANCE

Disclose the organization's governance around 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 where such information is material.

RISK MANAGEMENT

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

METRICS AND TARGETS

Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

The impact on reporting companies

The TCFD's recommendations will have five main effects, in our view:

1. **Climate issues will get more attention in the boardroom**. The report recommends that companies not only disclose their climate exposures but also describe the board's role in oversight and risk management. This emphasis on governance means boards will spend more time on these issues, and the audit and governance committees are likely to be deeply involved. Many boards will need to become better informed about climate issues, and for some it will be a steep learning curve. Fortunately, the TCFD embraces the concept of materiality, a disclosure standard boards are accustomed to, and which provides a usable framework for disclosing climate-related information.

2. **Companies will start to say more about climate risk**. The release of such a substantive and detailed report will make it hard for companies to maintain the status quo. It's likely the quantity and quality of the climate-related information companies disclose will grow, with much of it incorporated in the Management's Discussion & Analysis (MD&A) section of their financial reports. More ambitious firms will start to include the results of their scenario-modeling exercise too. In any case, the minimalist approach to climate disclosure is likely to end.

3. **Disclosures about climate-related risks will move into financial statements.** Not only will companies be saying more about their climate risks, but they'll be saying it in their financial reports. This will be a big change from current practice, and investors should welcome it. At the moment, companies report on things like their greenhouse-gas emissions and other climate matters in sustainability reports or regulatory databases or provide them to third-party data repositories like the Carbon Disclosure Project (CDP). Only the most diligent shareholders gather this information from these various sources. In the future, it will be found in the company's annual report, where shareholders can easily find it.

4. **The discussion about risk will broaden.** Today, company financial reports talk about climate change mainly as a regulatory risk. A typical filing says the company could face additional costs to comply with climate rules if they're enacted. But that's a very narrow view of climate risk. The TCFD recommendations will encourage companies to discuss how climate change could affect their physical operations, cost of materials and customer behavior — whatever risks meet the materiality standard.

5. **Climate disclosures will become more quantitative**. Most companies today, especially in the U.S., discuss their actions on climate change in qualitative terms. Quantitative measures will play a greater role in the future thanks to the TCFD recommendations. The use of scenario analysis is the first step to help companies get specific about the possible financial impact of climate change. It will be much easier for investors to assess the risk of individual companies and see where they stand against their peers.

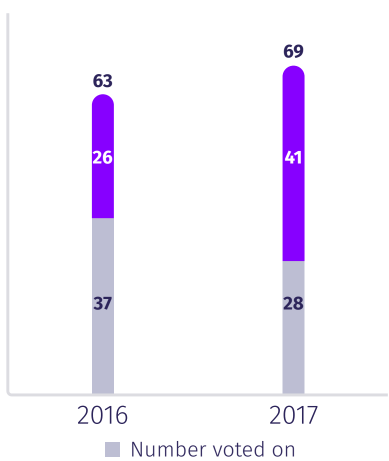
Rising investor interest in climate issues

Although the TCFD carries the authority of global finance ministers and central bankers, it has no way to compel companies and financial firms to improve their climate-risk disclosure. So it will be up to investors, regulators and other influential market participants to bring it about. Companies with better climate disclosure are likely to be rewarded with higher valuations and lower risk premiums, adding to pressure on those companies with weak or incomplete reporting.

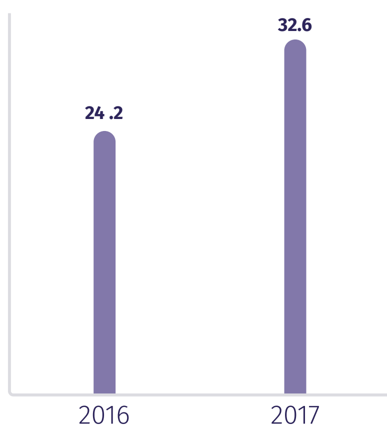
Big investors will play a critical role in this process, and there is evidence that climate risk is becoming part of their analysis. BlackRock, one of the world's largest asset managers, named climate disclosure as one of its engagement priorities for the coming year, ensuring that it will be a focus in many corporate boardrooms. BlackRock called the TCFD recommendations a "relevant roadmap" for companies and promised to "engage companies most exposed to climate risk to understand their views on the TCFD recommendations and to encourage them to consider using this reporting framework as it is finalized and subsequently evolves over time."[1]

Shareholder proposals regarding climate change are on the rise too.[2] In the 2017 proxy season, shareholders submitted 69 proposals related to climate change, up from 63 in 2016, and 28 proposals were voted on, with average support of 32.6 percent of votes cast, compared with 24.2 percent in 2016. Proxy advisors Institutional Shareholder Services ISS, an influential guide for many investors, recommended that shareholders vote in favor of 23 of the 28 proposals (82.1 percent) in 2017 and 27 of the 37 proposals (73.0 percent) voted on in 2016. (See chart below.)

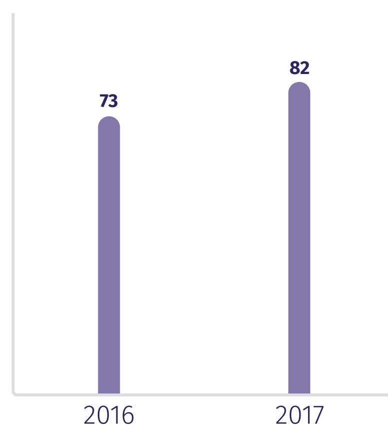
Number of climate-related shareholder proposals



Average shareholder support — percent of votes cast



ISS favorable recommendations percent of total climate-related proposals



1 "Blackrock Investment Stewardship Engagement Priorities for 2017–18," available at: https://www.blackrock.com/corporate/en-us/about-us/investment-stewardship/engagement-priorities.

2 "Shareholder Proposal Developments During the 2017 Proxy Season," Gibson, Dunn & Crutcher: http://www.gibsondunn.com/publications/Pages/Shareholder-Proposal-Developments-During-the-2017-Proxy-Season.aspx

Notably, climate-change proposals received a majority of the votes cast at Occidental Petroleum, PPL Corporation and Exxon Mobil. But the 2017 proxy season saw climate proposals on the ballot at financial services and technology companies too, indicating investor concern about this issue extends well beyond the energy sector.

Hank Boerner, chairman of the Governance & Accountability Institute, noted this trend, saying: "Over the past decade, a small but growing number of public companies have begun to say more about the performance against specific environmental, social and governance (ESG) criteria in response to investor interest in these issues. The TCFD recommendations could be the catalyst for widespread adoption of more robust climate-related financial disclosures by companies, bringing these issues into the mainstream so investors can factor them into their daily investment decisions."

In fact, there is growing evidence that climate is becoming part of the investment dialogue. Carbon footprint/emissions was the top environmental issue cited by investor relations professionals in a recent survey[3] of sustainable investing. In that report, Abigail Herron, head of responsible investment engagement at Aviva Investors, noted the importance of the TCFD recommendations, saying: "What we look for [in an annual report] … first and foremost [is] reporting on the basis of the Financial Stability Board's Taskforce for Climate Related Finance disclosure guidelines."

Gearing up for increased scrutiny

To manage the increased scrutiny from investors, companies should start preparing now to step up their environmental disclosures.

Here are some recommendations for getting started:

- Convene a climate risk disclosure working group to begin to pull together expertise and resources from across the company. This group should report to the board of directors.
- Collect data on climate impact of current operations and engage an external advisor to assist with the methodology and process if needed. Climate data should be collected and prepared at the same time and with the same rigor as financial data, not as an afterthought.
- Assess your communication channels for disseminating information on climate risk. Websites, investor presentations and online materials may need to be expanded and upgraded.
- Develop a "straw man" draft of climate disclosure, working closely with experts in financial communication and plain-English disclosure. This process will help speed the production of a final report once climate-risk data are gathered and analyzed for materiality.

Several companies have been leading the way in discussing the impact of climate change on their business, and their examples are instructive.

Financial reports by Statoil, BHP Billiton and ConocoPhillips were cited in the TCFD report as having useful disclosures about climate risk that incorporate scenario modeling. ConocoPhillips, for example, prepares a company-wide Climate Change Action Plan, as well as climate change management plans within its business units based on a range of greenhouse-gas emission forecasts and market costs.[4]

3 "Global IR Practice: ESG Communications," IR Magazine, September 2017.

4 ConocoPhillips 2016 Annual Report, p. 66. http://www.conocophillips.com/investor-relations/company-reports/Documents/ConocoPhillips_2016_AnnualReport.pdf

Resources

- In addition to examples of useful disclosure, companies can draw on several tools and resources to help measure, monitor and report climate-related risks and plans.
- Perhaps the best resource is the TCFD itself. The report and recommendations are impressive for both their detailed guidance on climate disclosure and the practical tools they offer. In addition to a 74-page report, the group provided specific climate disclosure guidelines for financial and non-financial companies and a technical supplement on the use of scenario analysis to present climate risks in a quantifiable way.[5] Together they offer a detailed handbook to help companies develop their disclosures about climate risks and opportunities. The Task Force itself will remain in existence through September 2018 to support and monitor adoption.
- There is also a deep community of technical advisors with expertise in measuring, evaluating and monitoring a company's climate risks. Working with senior management and operational professionals, these advisors can help the board determine the company-specific risk areas that should be considered for disclosure.
- Most of all, clear communication will be vital to a successful discussion of climate-related risks. Companies that can explain their risk exposures and present important information in a clear, easily accessible form will win credibility with investors and other stakeholders. Collaborative drafting software and cloud-based disclosure-management systems can streamline the writing and production of disclosure documents. And translating technical analysis into understandable, useful information for stakeholders will require specialized financial writers and editors experienced in drafting plain-English disclosure materials.

The strong momentum created by the TCFD report is driving greater disclosure of climate risks and opportunities, and companies should take steps now to prepare for a significant change in their disclosure practices. There's no one-size-fits-all solution for climate disclosure, and practices will evolve over time. Some companies will be early adopters and lead the way in shaping best practices, while others will follow their peer-group mean. But investors will come to expect every company — financial and non-financial — to say something about their material exposure to climate change.

5 The TCFD Final Report, Annex and Technical Supplement are available at: https://www.fsb-tcfd.org/publications/

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