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VIEWPOINT

INSIGHTS AND OPINIONS FROM BARINGA PARTNERS AND E3

Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)

From the impact of business on the environment, to the impact of the environment on business

Establishing the context

The biggest climate change related headline in 2017 was undoubtedly the announcement of the United States' withdrawal from the Paris Agreement.

Although a number of states, cities and businesses are continuing their support through the "America's Pledge" initiative, this marked a considerable setback for global efforts to coordinate reduction in emissions. Behind the front pages however, structural changes are occurring that will progressively redirect capital into more sustainable technologies and businesses, pointing to a gathering momentum behind the low carbon transition.

Increasingly, actors in capital markets are asking that the risks and opportunities presented by climate change should inform decision making. The credit rating agencies have been reminding borrowers that exposure to climate risk is part of their rating methodology. Institutional investors are coming under pressure to disclose their climate exposure, and have in turn increasingly been demanding greater transparency from investees. Correspondingly, asset managers have been writing to companies urging better reporting of climate risks.

In this context, the release in 2017 of the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), established in 2015 by the G20's Financial Stability Board, has been hailed as a landmark. The Task Force's goal is to support more informed decision making across the financial system (in investment, lending and insurance underwriting).

What are climate related risks and opportunities?

The effects of climate change, and society's response to it, will affect nearly all businesses, albeit in different ways. The TCFD provides a useful taxonomy of climate change related risks and opportunities, which is likely to become the lingua franca of this field.

In doing so, it aims to assist efficient allocation of capital, smoothing the transition to a low carbon economy and reducing the risk of abrupt market adjustments. Its recommendations provide a template for disclosure and incorporation into financial filings and corporate governance structures that can be applied to all sectors, financial and non-financial. More broadly, the recommendations demand a material increase in companies' and financial institutions' capacity to analyse and engage with climate related risks and opportunities.

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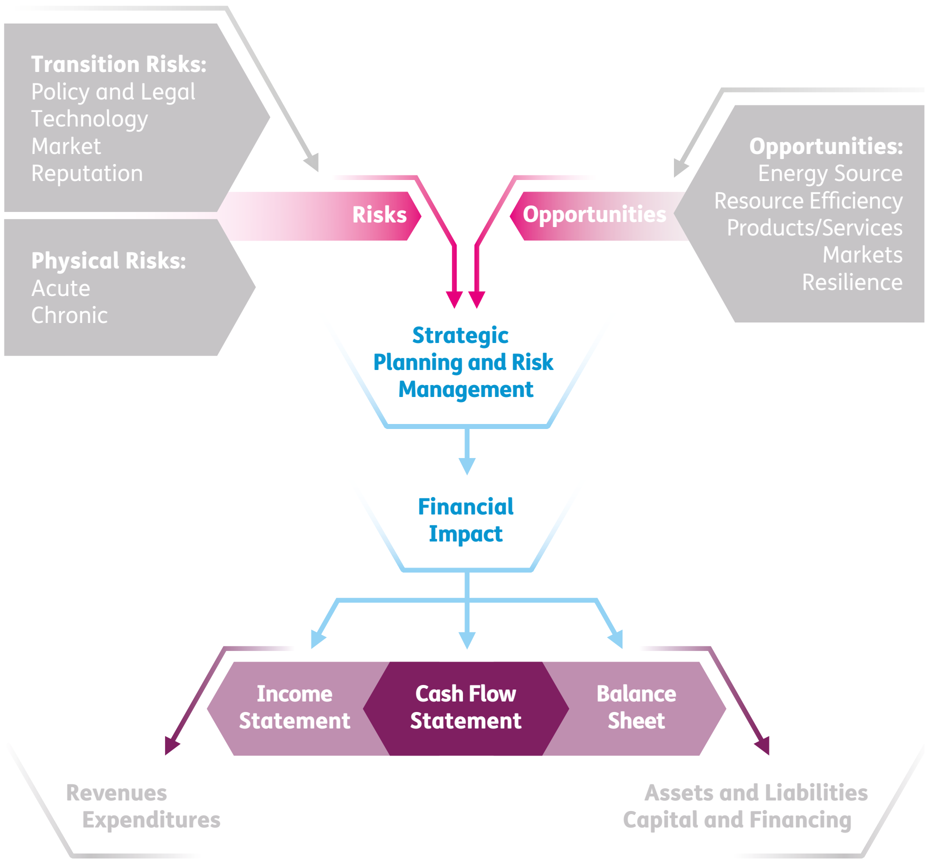
Risks are separated into those of a physical nature, which tend to be closer to the day-to-day debate of climate change, and those related to society's response (through changes in policy, technology, markets etc.) known as transition risks.

The latter are likely to be more pervasive in their impact, but also more difficult to forecast. The diagram below sets out this categorisation, and how each can impact an organisation's financial performance.



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

An overview of the TCFD recommendations

To demonstrate to stakeholders that climate risks and opportunities are being managed, the TCFD has set out recommendations for disclosure tied to four core elements of an organisation's operations: governance; strategy; risk management and metrics and targets.

Sitting under these overarching recommendations are disclosures that establish the framework for informing stakeholders on how the reporting organisation considers and assesses climate related risks and opportunities. These are supported by guidance for all organisations, and supplemental guidance for specific sectors.

The recommendations are intended to be implemented by all organisations with publicly listed debt or equity, and disclosures should form part of mainstream financial filings. The latter point is significant as it implies moving beyond reporting sustainability metrics to understanding the financial impact of climate related risks and opportunities, presumably in a quantitative manner. To put it another way, TCFD moves the debate beyond considering business' impact on the environment, to understanding the environment's impact on business. Given this, a forward looking assessment is required, and a key theme of the recommendations is the role of scenario analysis (discussed further below). It is also significant that disclosures will be subject to mainstream governance processes, including review by the CFO and audit committee, which must have the capability to scrutinise the analysis.

Governance	Strategy	Risk management	Metrics and targets
Board oversight Describe the board's oversight of CRROs	**Identification** Describe the CRROs the organisation has identified over the short, medium, and long term	**Process for identification** Describe the organisation's processes for identifying and assessing CRRs	**Metrics** Disclose the metrics used by the organisation to assess CRROs in line with its strategy and risk management process
Management's role Describe management's role in assessing and managing CRROs	**Impact** Describe the impact of CRROs on the organisation's businesses, strategy, and financial planning	**Process for management** Describe the organisation's processes for managing CRRs	**GHG emissions** Disclose direct, indirect, and, if appropriate, embedded GHG emissions, and the related risks
	Resilience Describe the resilience of the organisation's strategy, considering different climate-related scenarios, including a 2°C or lower scenario	**Organisation** Describe how processes for identifying, assessing, and managing CRRs are integrated into the organisation's overall risk management process	**Targets** Describe the targets used by the organisation to manage CRROs and performance against targets

CRROs = Climate-Related Risks (and Opportunities)

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

Implementation challenges

Implementing the analysis and procedures to sit behind the TCFD's recommendations will present organisations with new challenges.

Some of these challenges will be procedural and organisational. It will require collecting and processing new data, and tracking them against newly established targets. Governance processes will need to be adapted and new capabilities established. The greatest challenge however is likely to be conceptual and analytical: undertaking meaningful analysis that produces "decision useful information" to evaluate financial impacts, and ultimately informs development of robust strategy and risk management arrangements. The process anticipated is outlined below.

1. Assess materiality of climate related risks
2. Identify and define range of scenarios
3. Evaluate business impacts
4. Identify potential responses

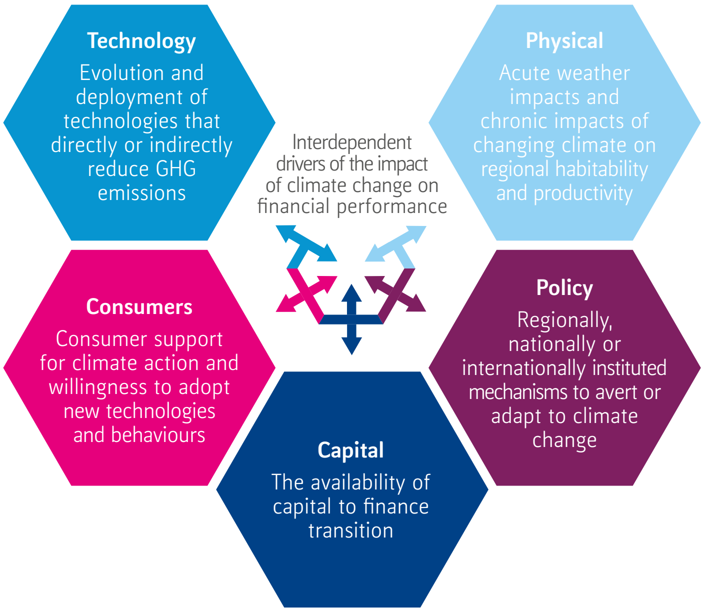
Adapted from Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities, TCFD

Assessing the materiality of climate related risks is an essential first step if the ensuing analysis is to be relevant and meaningful. It will require understanding a business' operations (supply chains and markets for inputs and outputs) through a new lens. This will need to be combined with a comprehensive knowledge of how physical and transition risks can manifest themselves in order to identify factors that may be material.

Developing suitable scenarios will be an unfamiliar area for many. Recognising the challenges in this area, the TCFD has provided supplemental guidance, setting out that scenarios should be:

- Plausible: scenarios should set out a credible pathway
- Distinctive: each scenario should be thematically distinct
- Consistent: scenarios must have strong internal logic
- Relevant: each scenario should contribute insights on the climate exposure of the organisation
- Challenging: scenarios should explore significantly different alternatives for the business environment

The impacts of climate change on the performance of financial assets are complex, and act through multiple interdependent drivers, from the policy response of governments to the attitude of consumers. Considering these simultaneously and consistently to build scenarios meeting the criteria above will require a robust methodology, but when well delivered the development process can provide an excellent means of engaging management thinking and structuring insightful debate. To support this process, Baringa, together with our U.S. partner E3, have developed a framework of interacting drivers as the starting point for scenario development, illustrated below.



The complexity of developing scenarios means that many organisations may choose initially to anchor their analysis to existing scenarios, from bodies such as the International Energy Agency. Standardised scenarios may emerge in time, designed for the needs of particular sectors and enabling ready comparison. The United Nations Environmental Programme - Finance Initiative's (UNEP-FI) pilot project on implementing the TCFD recommendations in the banking sector is a case in point. Even in these cases however, it is likely that considerable effort will be required to adapt scenarios to the specific needs of each business, for example in thinking through how relevant transition risks will evolve in an internally consistent way, or downscaling changes to the required level of sectoral and geographical granularity.

Evaluating the business impact of newly identified risks is also likely to present unfamiliar challenges, but is essential if the process is to provide decision-useful information. To quantify impacts, management will need to develop a new perspective on their business and an understanding of the dynamics of transition pathways. Inevitably, estimating the impact on financial statements of different scenarios will be subject to uncertainty, and good judgement will be necessary to provide investors and lenders with sensible guidance.

In contrast to earlier steps in the process, developing a strategic response to an analysis of risks and opportunities will be familiar territory. Nevertheless, equipping management with the necessary knowledge to engage with the subject, and structuring the discussion, will require experience.

Overall, the complexity of the subject means compliance with the TCFD Task Force recommendations will not be a single step, but rather a process, and the sophistication and format of disclosures will evolve as capabilities grow and standards in particular sectors emerge. An upfront effort will be required of organisations to establish a framework for managing climate related risks and opportunities, but an ongoing capacity to keep this framework up to date and relevant to the business will also be needed.

Why it's worth getting ahead

Implementation of the recommendations is voluntary, but there are likely to be advantages to organisations which choose to engage with the framework early.

- Some risks may have current or near term business impact, yet have evaded identification and consideration under existing planning exercises.
- The transition will present not just risk, but plentiful opportunity. Early identification of those opportunities will help position organisations to capitalise on them.
- Early engagement presents the opportunity to position an organisation as a leader, and take the driving seat in defining metrics and methodologies that may become standard in your industry.

Whilst the TCFD's recommendations are voluntary for now, there is increasing momentum behind them and they are becoming established as the benchmark to which other initiatives refer back. For example, in January 2018 the European Commission's High Level Expert Group on Sustainable Finance published its final report, recommending that the EU implement the TCFD's recommendations as part of the review of the Non-Financial Reporting Directive (NFRD). It is likely that over time pressure on organisations to comply will come from many directions, such as credit rating methodologies, and stock exchange listing requirements. The market itself may provide the ultimate motivation. Organisations that, through inadequate planning processes, take on risks for which they are not rewarded, or fall behind peers in the quality of their disclosures, may find that their equity valuations suffer and that their access to capital is diminished.

How we can help you

Together, Baringa and E3 are uniquely equipped to provide the diverse expertise required to analyse the impact of climate change related risks and opportunities on your business, develop your strategic response, adapt your internal processes and systems, and structure disclosures compliant with the TCFD recommendations.

Our Energy and Resources practice has deep understanding in climate change, the interdependency of different sectors and drivers in defining low carbon transition pathways, and collaborative scenario development. Our Finance, Risk and Compliance practice has deep expertise in advising on financial risks and navigating regulatory change. Our People and Process Excellence practice has extensive experience in embedding process and organisational change to secure enduring value.

Bringing these skills together, we can work with you to define and deliver your business' response to climate change.

About Baringa Partners

Baringa Partners is an independent business and technology consultancy. We help businesses run more effectively, navigate industry shifts and reach new markets.

We use our industry insights, ideas and pragmatism to help each client improve their business.

Collaboration is central to our strategy and culture ensuring we attract the brightest and the best. And it's why clients love working with us.

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About E3

Energy + Environmental Economics (E3) is a fast-growing energy consulting firm based in San Francisco, California that helps utilities, regulators, policy makers, developers, and investors make the best strategic decisions possible as they respond to technological advances and address customers' shifting expectations.

We provide a 360-degree understanding of markets, planning, policy, regulation, and environmental factors. We are committed to delivering clear, unbiased analyses that help clients make informed decisions.

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