Task Force on Climate-Related Financial Disclosures

29 April 2016

Dear Members of the Task Force,

Phase 1 Report of the Task Force on Climate-Related Financial Disclosures (TCFD)

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. We set the framework of codes and standards for the accounting, auditing, actuarial and investor communities and oversee the conduct of the professionals involved.

We welcome the steps the TCFD is taking to ensure that adequate consideration is given to the assessment of and reporting on the impacts of climate change. We believe that it is important for investors and companies to consider risks that might impact on business models and future performance over the longer term. The FRC promotes this through the Guidance on the Strategic Report[1], the UK Corporate Governance and Stewardship Codes[2] and its other activities.

The TCFD consideration of existing frameworks in its Phase 1 report and its focus on building on existing disclosure frameworks rather than creating a new regime is welcomed.

We would welcome an opportunity to engage further with the TCFD and share our experiences of developing codes, guidance, monitoring compliance and encouraging market-based improvements by reflecting company and investor views of good practice. Our Financial Reporting Lab[3] has planned projects on disclosure of business models, principal risks and viability statements that may be of interest.

Our overarching comments are noted below with our detailed responses to the survey attached. In the time available, we have not undertaken extensive outreach or research to develop our response nor have we sought to answer all questions.

---

[1] A copy of the FRC's Guidance is available at https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf

[2] Copies of the Codes are available at https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance.aspx

[3] Further information on the Financial Reporting Lab's projects is available at https://www.frc.org.uk/Lab

Timeline
While we understand that the TCFD has a mandate from the FSB and G20 to develop recommendations within a short space of time, we are concerned about the length of the consultation period and the ability of stakeholders to respond in a considered and meaningful way. We have responded within the timeframe requested but note that further consideration by the FRC on the issues raised in the months ahead is likely to identify other relevant points.

Whilst consideration of climate risks is breaking into mainstream business dialogue, deep understanding of the issues, the potential impact of intra-governmental agreements on the global economy and analysis of how companies' business models will need to adapt are still evolving. Similarly, reporting responses are still new with few examples of good practice to date which will undoubtedly improve over time through innovation.

We encourage the TCFD to target its outreach activities beyond those investors and preparers that are already immersed in the subject area of climate change. This will both increase awareness amongst stakeholders and better ensure disclosure recommendations are practicable, proportionate, relevant to meet the needs of the wider investment community and focus on entity specific issues.

Objectives
We support the objectives of the TCFD and welcome that it is focussing on financial risks and in particular those that could have a potential impact on future cash flows. We believe that this is important in identifying the boundary of information that would be relevant to investors' decision-making.

As with any project with multiple objectives there will be instances where a trade-off is necessary. Consistent principles are important, but absolute uniformity in disclosures detracts from careful consideration and communication of information that is relevant for its users.

Whilst climate related risks will be important to many companies any recommendations must be proportionate and balanced, to avoid excessive focus on one set of risks to the detriment of disclosures of the other principal risks and uncertainties a company faces.

Boards must retain responsibility for determining what disclosures, if any, on climate related risks are relevant and material. This requires an understanding of the potential impacts of climate change and legislative responses, and the application of judgement. Identification of factors to be considered by management when making such an assessment will be helpful.

Scope
In our view, it is important for the disclosure recommendations to apply to both financial and non-financial companies as the climate change risks could potentially impact any sector.

The recommendation should provide preparers and their boards an understanding of the factors to consider when assessing, mitigating and, where necessary, reporting the climate change risks they might face. Factors to consider might include the sensitivity of its business model to climate related legislation (for example, the existence of low carbon substitute products or processes); the energy use and carbon emissions of the company, its products and suppliers; the company's investment planning periods; and the geographical location of operations and its distribution channels. High risk sectors could then be used to illuminate those factors.

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

Users
We note from the Phase 1 Report that the intended users for the information goes beyond those making direct investments in companies to those further back in the capital supply chain. We welcome this to ensure more informed capital allocation decisions. However the disclosure recommendations will need to take into consideration the needs of the intended audience and be dependent on the type of preparer as different considerations will apply for climate related risks arising from companies reporting on their own operational activities in their annual report and those investing in a portfolio of assets or advising on investment activities.

We also encourage the TCFD to consider the placement of information outside the annual report when recommending disclosures that might go beyond the needs of the annual report's intended audience. We encourage reporting of more detailed voluntary information for investors or other users outside the annual report so that it does not detract from the key messages.

Development of a disclosure framework
We support the TCFD developing principles for disclosures and stress the importance of ensuring that any disclosure recommendations are flexible to enable a company to tell its story and allow preparers to apply judgement.

We highlight the FRC's 2012 report 'Thinking about disclosures in a broader context'[4] which sets out a roadmap for a disclosure framework. We suggest the following structure for a disclosure framework:

1. Identification of user needs
2. Considering the placement of disclosures
3. Applying materiality to determine when a disclosure should be provided
4. Developing principles for good communication.

We also consider that principles for good communication of disclosure are as important as the disclosure itself. We support the principles that are set out in the phase 1 report as these are aligned with the communication principles in the FRC's Guidance on the Strategic Report.

If you would like to discuss these comments or would like further information about our work, please contact Deepa Raval on 020 7492 2424.

Yours sincerely

Paul George
Executive Director, Corporate Governance and Reporting
DDI: 020 7492 2340
Email: p.george@frc.org.uk

[4] A copy of the report is available at https://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Thinking-about-disclosures-in-a-broader-contex-File.pdf

8th Floor, 125 London Wall, London EC2Y 5AS Tel: +44 (0)20 7492 2300 Fax: +44 (0)20 7492 2301 www.frc.org.uk

FRC Response to Task Force on Climate-Related Financial Disclosures (TCFD) Consultation

1. Which types of non-financial firms should any disclosure recommendations cover? List in order of importance.

5 Consumer Discretionary (auto, durables, retailing, etc.)

6 Consumer Staples (food, beverage, household etc.)

1 Energy (equipment, services, oil, gas etc.)

9 Health Care (equipment, services, pharma, biotech, etc.)

4 Industrials (capital goods, commercial services, transport)

8 Information Technology (semiconductors, software, hardware, etc.)

3 Materials (chemicals, construction, metals & mining, paper & forest, etc.)

7 Telecommunications (diversified, wireless, etc.)

2 Utilities (electric, gas, renewables, water)

We have prioritised the sectors but consider this arbitrary; disclosure recommendations should cover <u>all</u> listed financial and non-financial firms and initially focus on listed companies. The disclosure recommendations should provide guidance on the specific factors that management of individual companies should consider in determining if disclosures are relevant are necessary. Possible factors include business model, energy use and carbon emissions of the company and its products, investment planning periods and geographical location of operations.

Management should judge based on informed assessment of the risks they face, what is relevant and material to users.

2. **Which types of financial firms should any disclosure recommendations cover? Check all that apply.**

✓Banks (diversified, thrifts, mortgage, etc.)

✓Diversified Financials (asset management, investment banking/broker-dealer, consumer)

✓Insurance (brokers, multi-line, property, reinsurance, etc.)

✓Real Estate (REITS, management and development)

✓Credit Rating Agencies

✓Investment Consultants

✓Pension Funds/Schemes

Other

3.	**Which users in the financial sector should be considered as the target audience? Check all that apply.** ✓Investors (including insurance, asset managers, funds, pensions, etc.) ✓Banks (diversified, commercial, project finance) ✓Broker-Dealers and Investment Banks Credit Rating Agencies Consultants/Advisory Other

Climate Risk Dimension

4.	**For non-financial preparers of climate risk and opportunity information, what are the top three key concerns that you would like the Task Force to keep in mind in making our recommendations?**

Relevance: disclosures in the annual report on climate risks should focus on providing material entity-specific information to investors. The recommendations should be predicated on management's ability to understand and analyse the climate related risks to its business model.

Focus on principles: the disclosures recommendations should be principles based and focus on clear and concise communication. Prescriptive requirements may add comparability and compliance but can detract from the provision of entity-specific information and communication.

Understandability: the disclosure recommendations should be simple to apply, avoid jargon and include sufficient explanation so that preparers can clearly identify the objectives for providing the disclosure.

See FRC's Guidance on the Strategic Report for further information.

5.	**For users of climate risk and opportunity information, what are five specific points of information that you wish to secure?**

Due to the short timeframe for responding to this consultation, we have not been able to gather investor views on the specific points of information that they would find useful and relevant to their capital allocation decisions. However, some investors have told us of the need for further entity-specific information to understand how climate-related risks and related regulatory interventions may impact the long term success of businesses and their business models and how management have analysed and are mitigating those risks. This highlights the need for climate risks, where material and relevant, to be increasingly embedded in governance decisions and for the provision of forward-looking information.

6. **Are there any best practice disclosures of climate risks by companies that you would like to bring to our attention? What specific climate elements of this disclosure would you like to highlight? (Please limit to two examples)**

We have not performed a specific review of climate risks disclosure to identify those which are best practice and have been unable to do this in the short consultation period. We advise the TCFD to carry out targeted outreach to long-term investors to identify those disclosures that have been most informative to them and that have best met their objectives when assessing the robustness of a company's business model, its governance and the stewardship of its management.

As part of our monitoring activities, although some companies are referring to climate risk in their annual reports, the disclosures tend to be very high level and can be uninformative.

7. **"Transition Risk" in terms of climate is an evolving term. How would you define this risk? What specific disclosures would help measure it?**

We agree that "transition risk", as with the analysis and understanding of climate risks generally, is evolving and not yet widely understood. Our understanding of the term is the risks involved in moving to a low carbon-economy and considering the potential impact on a company's business model.

Possible disclosures could be the extent to which profits relate to carbon intensive activities or costs of convergence. The recommendations should go beyond defining the term and focus on building an understanding of the potential impacts to educate management who are not experts on the matter and to aid their development of entity-specific analysis. The TCFD should view the development of disclosures and measurement techniques as evolutionary informed by this increased analysis.

8. **Which three sectors do you think are most exposed to climate risks? For these sectors, how are physical, transition and liability risks best measured and reported?**

In our view, companies in the extractive, energy, industrial and manufacturing sectors are most likely to be exposed to these risks because of the factors noted in our response to question 1. However, any list cannot be exhaustive and within each sector the exposure will vary.

In the time available to respond we have been unable to give due consideration to models for risk measurement and reporting, but we highlight the danger that over-prescriptive guidance might stifle innovation in an evolving area of reporting.

We suggest that the TCFD could invite a sample of the largest companies in the most affected sectors to assist in the development of ideas.

9. **How should the task force consider the challenge of aggregate versus sector-specific climate-related financial risks and opportunities?**

There are two distinct concepts here – making an assessment of systemic risk using aggregate data and how investors can assess the risk to individual companies and sectors. We believe it is vital for the task force to consider how the information will be aggregated to make a meaningful assessment of the potential impacts on financial stability.

Systemic risk could initially be addressed by the use of scenario analysis. However, in the early years, a focus on company specific data is likely to be most productive. The TCFD should also consider the challenge of making the information accessible to other users (e.g. insurance companies) who would find aggregated information useful in analysing results. In responding to the challenge, the Task Force should ensure that an appropriate balance is struck between aggregating quantitative data and the need for qualitative data on risks and governance.

10.	**Is there a role for scenario and sensitivity analysis – for the non-financial and/or financial sectors? Please provide three specific examples.**

Yes. We believe that scenario and sensitivity analysis in both financial and non-financial sectors can be helpful in testing the resilience of a company's business model to risks and regulatory targets. However, the extent to which it is necessary or useful will depend on the specific factors affecting a company, the sector in which it operates, the resulting exposure to climate-related risk and the period over which these are expected to impact.

We believe that scenario analysis could be helpful to understand the effects of climate-related risks. For example, different levels of global warming, restrictions on carbon intensive activity.

Sensitivity analysis is widely used in the banking industry and in developing its recommendations and any disclosures in this area, the Task Force may wish to build on the experience of this sector.

Asset Class Dimension

11. **Which are the key asset classes that require initial attention? Are there any gaps that we should focus on? Within this, what are the top two priorities for action? (Limit 1000 characters).**

✓ Equities

Fixed Income

✓ Commodities

✓ Project and Infrastructure Finance

Real Estate

Private Equity

✓ Loans and other bank financing

Other

We recommend that further outreach targeted at actors in the capital supply chain be done to understand their information needs in identifying priorities.

Intermediary/User Scope

12.	**Considering the breadth of services the capital supply chain provides, please provide up to three examples of leading work (research or other) from sell-side brokers' investment recommendations, listing rules of stock exchanges, portfolio management and stewardship examples by fund managers, fund-manager recommendations by consultants, or others we should consider.**
13.	**Please identify three examples of existing practice of climate risk disclosures you consider to be effective by investment banks, stock exchanges, investment managers, investment consultants and asset owners? Please indicate preparer and type of disclosure.**
14.	**How can climate risk information be simply summarized for retail investors? What standards or mechanisms exist for assuring end investors that climate risks and opportunities have been considered in the way that their savings and investment and pension products have been managed?**

As we are not users of the information we are not best placed to answer these questions.

Macro Scope

15.	**In conducting macroeconomic analysis, what are the top three key measures of macroeconomic climate risk performance when seeking to measure the extent to which the global economy is transitioning towards net zero emissions?**
16.	**One way to measure transition risk is by considering disclosures based on sector/market analysis. What scenario planning work is currently available in this area?**
17.	**The United Nations Framework Convention on Climate Change (UNFCCC) five yearly "global stocktakes" seek to establish in part whether financial flows are consistent with the less-than-two-degree scenarios. Are there any climate- risk disclosure recommendations that would appropriately feed into such an effort?**

As we are not users of the information we are not best placed to answer these questions.

18.	**How should the Task Force define “success”?**

In our view, an uptake of the proposals by companies and evidence of users benefiting from the resulting disclosures would be one measure of success. However, in advance of this the recommendations should be capable of being incorporated into existing frameworks.

We consider that the TCFD is already playing an important role in raising awareness of the potential impacts of climate change and the need for appropriate disclosures by those companies that are most affected. These factors also contribute to success.

Evidence of increased consideration of risks arising from climate change by company boards should also be an indication of success. We believe that consideration of the governance aspects should go hand in hand with the reporting. The FRC has experience in both these areas and we would welcome the opportunity to provide further input.

19.	**What are the key barriers that you believe the Task Force needs to overcome?**	

We consider that the Task Force within a short space of time needs to improve education and understanding of climate-related risks and the potential impacts on financial stability, investments, businesses and asset values. Without this it will be difficult for companies and others to be engaged in the debate and to develop modes of analysis and disclosures proportionate with the climate risks they face. Significant improvements may not be immediate but practice will evolve over time. This will include encouraging behavioural change by boards and others.

There is also an increasing disclosure burden being placed upon companies which is adding to costs for companies and the Task Force needs to be mindful of this.

Climate-related information may be highly uncertain and it may be difficult for companies to provide meaningful and reliable information against this backdrop. There may also be a reluctance by companies to provide disclosures where they could be seen as commercially sensitive.

20. **Is the Task Force focused on the appropriate set of topics for its Phase II work plan?**

✓Yes

No

21. **What additional topics should it consider?**

Before finalising its disclosure recommendations, we believe that the Task Force should field-test these with a range of investors and companies to ensure that any information produced meets the needs of the users and is also practicable for preparers.

The Financial Reporting Lab at the FRC has experience in facilitating this type of process and would be open to sharing ideas in this area.

22. **The Task Force plans to reach out to a broad sample of key stakeholders in the preparer, user and standard setting communities. Are there particular types of entities or organizations that you believe the Task Force should reach out to?**

We believe it is important for the Task Force to reach out to standard setters and regulators so as to benefit from their experience of developing disclosure standards and guidance. As an integrated regulator that is responsible for developing guidance on narrative reporting, the UK Corporate Governance and Stewardship Codes and accounting standards the FRC has relevant experience and stands ready to help including drawing from the monitoring of the quality of information in annual reports.

We also note that the composition of the Task Force includes preparers and users that are likely to already have a particular interest in reporting in this area. We consider that it is essential for the Task Force to engage more widely with other investors and preparers outside the sectors/organisations already involved to ensure that any disclosure recommendations are appropriate and taken up broadly.