TCFD: A catalyst for transformational climate adaptation?

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This commentary is part of a series on emerging issues from Adaptation Leader.

The Task Force on Climate Related Disclosures (TCFD), an initiative of the Financial Stability Board (FSB)[1], offers a framework for disclosure of climate risks. Despite the generally positive response and resulting buzz, in particular among advocates for climate action by businesses and those wanting to get on the bandwagon, the uptake of TCFD framework has been slower than its proponents had hoped. With time, the levels of disclosure will likely increase with more governmental mandates and shareholder activism on climate action. But it is the quality of the disclosures that is critical in meeting the existential challenge of climate change. Meaningful climate risk disclosure must address both the sources of climate risk to the reporting entity and the actions it intends to take in response.

There are, of course, two sides of climate action that must be addressed: mitigation (GHG reduction) and adaptation. Economic and social survival can, we assert, only be achieved through both rapid declines in greenhouse gas emissions, and, critically, armed with foresight on the impacts of climate change, decisive action to adapt to these impacts.

Can TCFD stimulate adequate movement on both tasks? We believe that on its current trajectory, the answer is a clear "no." In their current form, the TCFD recommendations lack the specificity and enforcement mechanisms needed to induce broad scale changes in corporate disclosure. Could they contribute to such a transformation, or is this asking too much? We believe that with modifications to the recommendations and the resources to guide climate related disclosure, TCFD's activities could lead to important improvements.

Directly, we suggest an increased emphasis on physical climate risk in disclosures, and further encouragement of strategy resilience through climate adaptation as precipitated by these same disclosures. Indirectly, we see TCFD as an important component of a framework, perhaps kickstarted by the fiduciary and reputational risk discovered through disclosure, that develops within and outside of corporations and ultimately works to enable corporate climate adaptation planning.

As corporate leaders realize that they have the potential to help their organizations adapt, thrive, and gain competitive advantage through adaptation, the TCFD recommendations can spur an economic and social transformation. The resulting adaptation solutions also could inform policy and resourcing of well-adapted public infrastructure and services as corporates better understand the magnitude of physical climate risks and needs for public-sector adaptations (e.g., the roads that supply businesses and allow market access, the disaster risk reduction plans, facilities, and services that enable plants to quickly re-open during hurricanes)., Such understanding also may translate into greater social and political will for adaptation to be seen as a co-equal component of climate action.

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[1] The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system. For more information visit: https://www.fsb.org/about/

<u>TCFD in a Nutshell:</u>

The Task Force on Climate-Related Financial Disclosures (TCFD) was established in December 2015 by the Financial Stability Board (FSB). Its purpose was to develop a set of voluntary climate-related financial risk disclosure standards for companies to inform investors about their climate-related risks.

TCFD, chaired by the businessman and politician Michael Bloomberg, has issued voluntary disclosure recommendations since 2017 that aim to provide a structure and impetus for corporate disclosures, including risks and opportunities. The recommendations are in the areas of governance, strategy, risk management, and metrics and targets.

TCFD has the expressed support of 1,340 companies with a market capitalization of $12.6 trillion and financial institutions responsible for managing assets of $150 trillion. More than 100 regulators and governmental agencies support the TCFD, and New Zealand, the European Commission, and the United Kingdom are making TCFD reporting recommendations a requirement. But even in the face of this momentum, there is evidence that actual levels and quality of disclosure are wanting. In fact, FSB's 2020 status report concludes "the disclosure of climate-related financial information is low in general."

TCFD and Adaptation: Missing Pieces

But before considering what to do in response to inadequate levels of disclosure, let's first understand what is missing. We will then propose reforms and new initiatives that could help build out the approach put forth by the TCFD and help meet the challenges posed by an appropriately complete concept of climate action (mitigation *and* adaptation).

- ***TCFD steers towards carbon exposure, "transition risks"***

  TCFD risks are broadly defined into two categories: physical climate risk, and "transition risks." Physical climate risks are risks of impacts caused by flooding, droughts, and storms. Transition risks are the risks a company may face when society forces it to curtail its greenhouse gas emissions, and the risks of impacts caused by policies and investments that lower emissions such as reductions in fossil fuel demand.

  The TCFD Guidelines recommend the use of scenario analysis to support disclosures across both risk categories. Considering the high uncertainties surrounding climate risk estimates, this is a sensible recommendation. However, TCFD implementation of scenario analyses may insufficiently emphasize physical climate risks. Considering the leadership of the Bank of England and the UK government in implementing TCFD[2] requirements, their influential 2021 biennial exploratory scenario on the financial risks from climate change is disappointing. The initial discussion paper considers only the three lowest emission scenarios out of the four alternatives, excluding, from the perspective of climate change, the worst case scenario (4.1°C – 4.8°C above pre-industrial by the end of the century).

By limiting their analysis to the three scenarios that assume that policies to limit emissions will to some extent succeed, they suggest to the reader that the Bank of England's senior management understands the extent to which transitional risks could affect their business. While this is important, it is odd that the "policy-failure" (or put differently, "no action") scenario is not included, especially considering that historically, greenhouse emissions policies usually have failed to meet their targets. Yet by excluding the high emissions scenario, reporting companies (Bank of England included) may be presenting an overly optimistic picture of their state of climate change readiness and ignoring a realistic scenario of extreme climate change, one in which impacts are greatest and adaptations are most critical.

- ***Adaptation strategy is under-emphasized***

Of particular concern for those of us who believe that adaptation to climate change is a potentially existential imperative, only 7% of companies in the latest review by the FSB "disclosed information on the resilience of its strategy." Although "resilience of its strategy" is not defined in the report, there is cause for concern, to the extent that reporting entities are not applying sensitivity analysis or other methods to evaluate the robustness of their findings regarding their ability to adapt to physical risks posed by climate change.

Indeed, the short shrift given to adaptation strategy is, viewed from a distance, quite shocking. Among the early guidance provided to any junior staffer in a corporate setting is some variant of, "don't just bring a problem to my attention, tell me how you propose to solve it." In a climate action context, then, the response(s) being planned or taken to adapt to a changing climate (rather than reporting on the firm's contribution to the problem through greenhouse gas emissions) is of primary importance.

Finally, if strategy resilience is not widely reported, then it will be almost impossible for investors and the public to understand whether a company has a robust adaptation strategy. Moreover, because so few companies report physical climate risks, and any corresponding adaptation risks, TCFD creates no incentive for forward-thinking corporations to tout - or even formulate - adaptation strategies.

- ***Adaptation metrics need further development***

The FSB has concluded that TCFD's work to date has lacked sufficient guidance on metrics and targets. In late 2020 and into January of 2021 a consultation is underway. This is encouraging, as without a clear presentation of metrics on climate exposure, sensitivity,

[2] Former Bank of England Governor Mark Carney was also FSB chair when TCFD was formed and the UK government has announced its intention to make TCFD-aligned disclosures mandatory across the economy by 2025, making it the largest sovereign nation to impose such a requirement. See: https://www.gov.uk/government/publications/uk-joint-regulator-and-government-tcfd-taskforce-interim-report-and-roadmap

adaptive capacity, and vulnerability reduction, disclosures will be difficult to interpret and factor into investment decisions, both within companies and by external stakeholders.

The consultation, however, looks at high-end financial metrics (value at risk, etc.), not the underlying metrics that are necessary to understand physical climate risk and adaptation. Adaptation metrics are especially challenging. The International Platform for Adaptation Metrics (IPAM) notes that, "one of the key barriers over and again acknowledged is the need for a global effort to build consensus on metrics to help governments, businesses, and financial institutions to identify and steer investment."

- ***Limiting scope to financial disclosure is a missed opportunity***

  The TCFD, and it's in the name, is focused on financial disclosure. The question, then, is by only looking at financial impacts, is TCFD doing enough to ensure that corporations understand what to do to adapt and be more climate resilient? Clearly, understanding asset value at risk, for instance, is useful for understanding investment risk and pricing. But corporations need to explore the social and broader contextual, market, employee, customer, and supply chain environmental/physical climate risks, and the adaptation actions they are implementing or could undertake as well, if they are to truly consider the interests of all of their stakeholders (employees, supply chain, etc.). This is not to turn TCFD into a public relations event, although we note that TCFD outputs are four times more likely to be included in corporate sustainability, rather than financial, reports, suggesting that there is an appetite for this type of disclosure among a wide range of stakeholders.

- ***Focus on the disclosing corporate entity ignores important systems effects and solutions***

  Unlike carbon emissions and mitigation, physical impacts, risks, and adaptation to climate change permeate whole systems, and for many industries, there are common but complicated issues that may require sectoral disclosures or initiatives, so as to give individual companies a sufficient level of understanding of the types, range, and extent of climate impacts on their future assets, productivity, markets, and broader stakeholder community.

  Systems understanding of physical risks may come down to identifying the most important scale of and interplay among different assets, both those that are owned by a company, but also the status of suppliers, public goods like water resources and infrastructure, and social systems such as schools and access to health care, that affect a company's exposure to physical risk but also their adaptive capacity.

TCFD can drive private sector climate adaptation

As we are looking at a future climate that is uncertain, TCFD disclosures, if undertaken to instigate corporate adaptation foresight and nimble planning, could become a key aspect of corporate competitiveness. These disclosures will create positive feedback loops as companies strive to become best adapted and encourage public sector adaptations that further grow their competitive advantages. Extensive, high-quality disclosure under TCFD recommendations could lead to a more climate-resilient global commons.

How could TCFD further contribute to corporate value creation and investment decision making, as well as to the transition to a climate change-resilient economy and society? To begin, we must surmount the considerable remaining hurdles impeding effective, action-oriented disclosures of physical climate risk and adaptation. Adaptation Leader suggests that FSB, corporate entities, and other critical stakeholders (e.g., trade associations, governments, research bodies) looking to improve their guidelines, policies, and disclosures focus on the following measures:

- Ensure that climate mitigation “policy failure” scenarios are considered to enable adaptation planning and enlightened investment decisions for extreme climate disruptions. The Covid-19 pandemic demonstrates that extremely disruptive and global natural events can and do happen.

- Require and make TCFD guidelines and national disclosure policies clear on strategy resilience, including explicitly the need to include adaptation planning strategies.

- Redouble efforts to integrate not just financial metrics, but also support efforts to achieve consensus on and provide guidance on coherent climate impact and adaptation metrics in disclosures.

- The FSB, national governments, and industry associations should prepare guidance, approaches, sector wide-scenario planning methods, and industry specific tools, as well as support capacity building for evaluating corporate physical risks, impacts, and adaptation options. Local and regional groups (e.g., governments, associations, research bodies) could then develop system-wide scenarios and impact assessments to better inform localized corporate disclosure of physical climate risks. This in particular will enable small and medium sized enterprises to report.

- At a minimum, the FSB should work with non-financial governance and standards bodies to encourage greater integration of financial disclosure with environmental and social impact, risk, and adaptation plans and disclosures.

The FSB has taken on a difficult but important task, and thus far through TCFD it is making some noteworthy progress in instigating improvements in both the breadth and depth of climate disclosures. If we can build on the existing momentum for more extensive and meaningful climate disclosure, it may be possible to build the vastly greater direct action and social and political resolve needed to achieve a global economy and society that is resilient to the dramatic changes in climate that lie ahead.