ALLEN & OVERY

April 2021

Towards mandatory TCFD

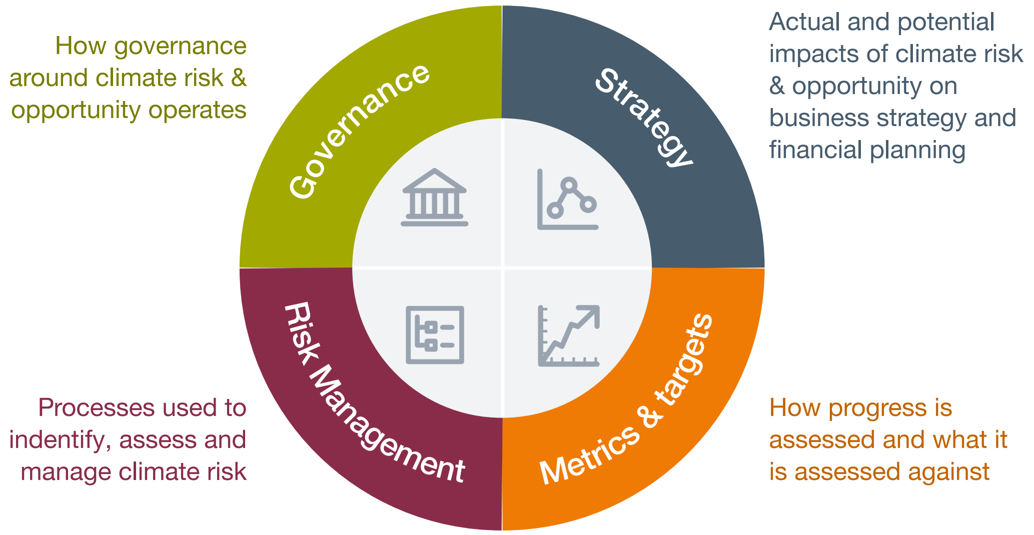
The recommendations of the Task Force for Climate-related Financial Disclosures (TCFD) are voluntary, but are fast gaining traction within sustainability/ESG policy and regulation.

What is TCFD?

The TCFD framework is not about how to disclose, but what to disclose against. It is not a corporate reporting standard; rather it is way of understanding how firms are approaching the financial risks and opportunities related to climate change.

The TCFD was established by the Financial Stability Board (**FSB**) to establish common principles for how companies and other organisations provide information on the risks and opportunities associated with climate change to external stakeholders. It published its final recommendations (the **Recommendations**) in 2017.

The recommendations are centred around four core organisational themes:



Under each of these themes, the Recommendations specify what information organisations should publicly disclose in accordance with national disclosure requirements.

The Recommendations and their accompanying implementation annex include:

- **Seven principles of effective disclosure.**
- **Guidance for all sectors** on each of the recommended disclosures, including where they should be aligned to other disclosure frameworks.
- **Supplemental guidance for the financial sector**. In its mandate to the TCFD, the FSB placed particular emphasis on the role of the financial system in climate-related financial disclosure. The TCFD organises the financial sector into four industries – banks, insurance companies, asset managers and asset owners – with specific guidance for each industry.

– **Supplemental guidance for the non-financial sector**. The TCFD also identified certain industries within the non-financial sector that are more likely to feel the financial impact of climate change. These are materials and buildings, agriculture, food and forest products, transportation and energy. The supplemental guidance provides additional considerations for these industries.

– **Guidance on scenario analysis**. Given the longer time horizons needed to gauge the impact of climate change on many businesses, one of the tools recommended for understanding the risks of climate change and developing a strategic response is scenario analysis. This is a process for examining and evaluating the implications of different postulated sequences of events. The Recommendations included initial guidance on scenario analysis in the context of climate risks, with a guide specifically for non-financial companies published in 2020.

– **Guidance on risk management integration and disclosure**. Noting the lower levels of reporting on risk management, the TCFD published a further guide in 2020 to address some of the potential implementation issues.

The Recommendations are voluntary, but have steadily gained traction. Nearly 60% of the world's 100 largest public companies support or report in line with the Recommendations. Over 1700 companies globally are now supporters, an increase of 85% in less than 2 years.[1]

Given that initial implementation timelines have measured in the years, the number of reports in the public domain are indicative of an increasing level of commitment to the TCFD principles.

However, reporting still remains nascent. Reporting on the potential financial impact of climate change on strategy remains low, with only 1 in 15 reports including disclosure on this theme.[2] Asset manager and asset owner reporting was described by the TCFD as "likely insufficient" in the 2020 status report. Whilst some companies have committed to net zero goals, articulation of how they will actually achieve this is low.[3]

Demands for greater compliance with the Recommendations are rising. Increasingly, policymakers have been incorporating the TCFD framework into their policy frameworks.

> "Climate change considerations are becoming increasingly common in the private sector… However, greater disclosure and transparency are urgently needed."
>
> Michael Bloomberg, Chair, TCFD, October 2020

What is climate financial risk and opportunity?

Climate risk can be broadly divided into two categories:

Physical risk: The acute and chronic physical risks arising from climate change.

– **Acute physical** risks are event-driven, such as more severe bushfires or storms.

– **Chronic physical** risks result from longer-term shifts in climate, such as sea level rises or changing flood plains.

Transition risk: Risks related to the transition to a decarbonised economy. These include:

– **Policy risk:** Risks arising from changes in public and regulatory policy to incentivise contributions to, or discourage actions deleterious to, climate targets.

– **Litigation risk:** Increased litigation by shareholders, investors, counterparties and stakeholders.[†]

– **Technology risk:** Increased obsolescence as more resources are devoted to technological solutions.

– **Market risk:** Shifts in supply and demand for goods, services and commodities as the economy is reoriented towards climate targets.

– **Reputational risk:** Changing customer and community attitudes towards an organisation's contribution or otherwise to climate targets.

These risks can translate to financial risks. For instance, policy or technology risk might result in stranded assets. Litigation risk might increase reputational risk and increase costs. Market risk might adversely change revenue mixes.

They can also translate into financial opportunities. In one estimate[‡], USD3-5 trillion will be required each year to meet the Paris Agreement commitments, which will result in opportunities in private finance. Other opportunities identified by the TCFD[‡‡] include reduced operating costs from improved resource efficiency and increased revenue from access to new markets.

[1] TCFD 2020 Status Report, October 2020

[2] TCFD 2020 Status Report, October 2020

[3] Climate Thematic Report, Financial Reporting Council, November 2020

[†] Note that some policymakers and commentators will treat this as a separate category of risk.

[‡] "Climate Financial Markets and the Real Economy", Global Financial Markets Association and Boston Consulting Group, December 2020

[‡‡] "Final report: Recommendations of the Task Force on Climate-related Financial Disclosures", June 2017

UK plans to mandate TCFD

The UK has placed heavy emphasis on the TCFD framework in its approach to the transition to a decarbonised economy.

PRA requirements for banks and insurers

The Bank of England was a pioneer in bringing the TCFD Recommendations into the regulatory domain. The Prudential Regulation Authority's (**PRA**) 2019 supervisory statement on climate financial risk (SS3/19) reflects the core principles of the TCFD approach. It sets out the PRA's expectation that banks and insurers embed consideration of climate financial risk into firms' governance, strategy and risk management processes, utilising scenario analysis where proportionate.

The statement directs firms to consider whether they need to go beyond existing disclosure requirements and to prepare for the "increasing possibility" that climate disclosure will become mandatory in multiple jurisdictions. The PRA specifically exhorts engagement with the TCFD framework.

Whilst the statement applies to banks, building societies and insurers regulated by the PRA, the impact of implementing these requirements will be felt across the investment chain.[4]

Firms have until the end of 2021 to complete their implementation, with the PRA drawing particular attention to current deficiencies in disclosure.[5]

New TCFD "comply or explain" disclosure requirements for premium listed companies

New "comply or explain" TCFD disclosure requirements were introduced by the Financial Conduct Authority (**FCA**) for premium listed companies on 1 January 2021. Under the new Listing Rule, premium listed companies will need to include a statement in their annual financial reports confirming:

– Whether it has made disclosures consistent with the Recommendations in its annual financial report.

– Where in its annual financial report (or other relevant document) the various disclosures can be found. If some or all of these disclosures are not in its annual report, the company will need to specify what disclosures are contained in the other document, where the document can be found and the reason for disclosing in that document and not the annual financial report.

– Where it has not made disclosures consistent with all of the Recommendations, the company must include an explanation of which Recommendations it has excluded and why. The issuer must also disclose any steps it is taking, or plans to take to be able to make those disclosures in the future, and the timeframe in which it expects to be able to do so.

The new Listing Rule applies to accounting periods beginning on or after 1 January 2021.
For more information on the new requirements, please see our alert.

> "Given the urgency of the climate threat, a voluntary approach to climate related financial disclosure may not be sufficient. The Government and regulators have concluded that the UK should consider moving towards mandatory TCFD-aligned disclosures across non-financial and financial sectors of the UK economy over the coming years to help accelerate progress."
>
> "A roadmap towards mandatory climate-related disclosures"
> UK joint regulator & government TCFD taskforce, November 2020

[4] Eg. The PRA makes it clear that firms are expected to engage with their clients and counterparties to obtain the data necessary to ascertain its climate financial risk exposure

[5] Dear CEO letter on SS3/19, dated 1 July 2020

New TCFD-aligned requirements for occupational pension schemes

The UK government has consulted on draft regulations to introduce TCFD-aligned requirements for occupational pension schemes as part of a wider focus on sustainability issues – you can read more about this in our separate article. The proposals would introduce new obligations in relation to how such pension schemes address climate risk and opportunity in their governance, strategy and risk management. They require schemes to conduct scenario analysis and to measure performance against climate-related metrics and targets as well as introducing reporting requirements in line with the TCFD Recommendations.

For the largest schemes and authorised master trusts, the new obligations will come into effect later this year. If a scheme has over GBP5 billion in assets (excluding bulk and individual annuity contracts) as at the first scheme year end to fall after 1 March 2020, then it must:

- meet the climate change governance requirements for the remainder of the scheme year that is ongoing as at 1 October 2021, and for subsequent years;
- publish a TCFD report within 7 months of the end of the scheme year which is underway on 1 October 2021 and include a link to it in the annual report for that scheme year (and subsequent scheme years).

For schemes with assets of less than GBP5bn, the test will be whether they have assets of more than GBP1bn as at the first scheme year-end date after 1 March 2021, and the governance and reporting deadlines will be one year after those described above.

The government also intends to consult on TCFD-aligned measures in the Local Government Pension Scheme in 2021, which would be implemented by 2023.

New TCFD-aligned disclosure requirements for asset managers, life insurers and FCA-regulated pension providers

The FCA intends to consult on new rules for firms that it regulates that set investment strategies and make investment decisions on behalf of institutional and retail investors. The aim of any new requirements is to promote TCFD-aligned disclosures to such firms' clients and end-investors.

The proposals are expected to include entity-level disclosures on strategy, policy and processes aligned with the relevant TCFD Recommendations, as well as targeted fund or portfolio-level requirements.

The FCA is expected to consult on new proposals in the first half of 2021 with a view to finalising the new rules by the end of this year. The regulator is considering phasing in the obligations based on the size and interconnectedness of the firms in question.

The FCA is expected to consider TCFD-aligned disclosures for listed open-ended and close-ended investment companies in parallel.

New TCFD-aligned disclosure requirements for UK registered companies

The UK government is consulting on new requirements to require companies registered in the UK to make TCFD-aligned disclosures in their annual report and accounts in amendments to the Companies Act 2006.

Mandatory TCFD reporting would apply to:

- all UK companies that are currently required to produce a non-financial information statement, banking and insurance companies;
- UK-registered companies admitted to trading on AIM with more than 500 employees;
- Other UK-registered companies (including private companies) with more than 500 employees and a turnover of £500m+; and
- LLPs with more than 500 employees and a turnover of £500m+.

The proposed disclosure would be based on the four core themes of TCFD, and would need to form part of companies' Strategic Report or, in the case of LLPs, either the Strategic Report or the Energy & Carbon Report of their Annual Report.

The new requirements are expected to apply to accounting periods starting on or after 6 April 2022.

Further expansion in 2023?

These measures are only the first step. Further reviews are expected from 2023 onwards, which could result in expansion to the scope of affected occupational pension schemes and UK-registered companies, as well as amendments to the requirements under all of the interventions as best practice in climate financial risk develops.

International developments

Whilst the UK currently has the most ambitious commitment to the TCFD framework, it is by no means alone. Countries all around the world are examining how to incorporate the Recommendations and principles underpinning them into their policy response to climate change.

Canada
- Canadian government announces official support for TCFD
- Mandatory reporting of climate risks a condition of Bank of Canada Covid-19 bailouts
- Ontario taskforce report has recommends TCFD-compliant disclosure mandatory for issuers and comply or explain GHG disclosure aligned with TCFD

Switzerland
Federal Council expected to introduce mandatory TCFD requirements

Singapore
MAS expects firms to consider environmental risk in their governance and risk management, and disclose by reference to frameworks such as TCFD

Hong Kong
Mandatory TCFD-aligned disclosures for financial institutions and listed companies by 2025

Japan
Council of Experts recommends enhanced disclosure based on TCFD recommendations for Prime Market listed companies

Mexico
Banco de México recommends development of a regulatory/supervisory strategy following TCFD recommendations

U.S.
- Federal Reserve joined NGFS
- Secretary of Treasury expressed support for TCFD

Chile
CMF plans to integrate climate risk into prudential supervision and promote climate disclosure

Brazil
Banco Central Do Brasil plans to require banks to disclose in line with TCFD

EU
ECB published guide on climate and environmental risk based on TCFD principles

South Africa
National Treasury recommends standards on environmental and social risks incorporating TCFD recommendations

Australia
- ASFI calls for ASX300 TCFD reporting on an "if not, why not" basis
- APRA consulting on new guidance based on the TCFD framework

New Zealand
First country to introduce mandatory TCFD "comply or explain" disclosure for financial sector

International
- The Network for Greening the Financial System (NGFS) promotes principles of climate risk established by the PRA across the world
- COP26 Private Finance Strategy promotes greater adoption of TCFD
- IFRS Foundation forms working group to develop global sustainability reporting standards built on TCFD recommendations

Conclusion

The TCFD framework is rapidly shifting from being a voluntary approach to the predominant public and regulatory policy response to climate risk. The trend towards mandatory TCFD will have wide-reaching ramifications across sectors and across borders, both directly and indirectly.

Author: Kelly Sporn