

Responsible Investing Perspectives

ESG Viewpoint

The Taskforce on Climate-related Financial Disclosures: What does it mean for investors?

Key summary

- Climate change presents a potential systemic risk to companies in key sectors, and the investors who own them
- The Taskforce on Climate-related Financial Disclosures (TCFD) sets out a framework and metrics to guide consistent risk reporting
- Investors will be expected to improve their own disclosure—and to play their part in supporting better reporting by the companies they invest in

What is the Taskforce?

On June 29, a comprehensive new report was issued with the ambition of being the definitive guide to how investors, and the companies they invest in, should analyze and report on the risks and opportunities presented to their future business by climate change.

The group behind the report was the industry-led Taskforce on Climate-related Financial Disclosures. The origins of the Taskforce lie not with ESG or responsible investment, but with central banks. In the aftermath of the financial crisis, regulators have been asking themselves, what might the next systemic risk to the global economy be? Mark Carney, Governor of the Bank of England, believes that climate change might be such a risk, and set up the Taskforce with the goal of providing data to allow corporations, investors and ultimately regulators with the information to see how big this risk may be, and how it can be managed.

The Taskforce was established by the Financial Stability Board, the international grouping of central banks, as an industry-led initiative, with 32 members chaired by Michael Bloomberg. Its final report was issued in June, and includes specific recommendations on what types of disclosures on climate risk should be made by corporations and investors. The Taskforce stresses the need for this disclosure to be high quality—recommending that it appear in mainstream financial reporting.

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Why should investors pay attention?

The recommendations have no legal force, which begs the question—should investors care? The answer is yes, for two reasons. First, improving the state of corporation disclosure on climate change is in our own self-interest. If we can encourage companies to tell us more about the risks they face, we can in turn make better-informed investment decisions.

And second, as investors, we ourselves will have the spotlight turned on our own disclosure, with Taskforce findings already being incorporated into best practice standards. Those investors who are signatories to the UN Principles for Responsible Investment will be asked questions—voluntary, for now—based on the Taskforce in the upcoming reporting round: For those that are listed companies, the Carbon Disclosure Project will be incorporating Taskforce recommendations, and the European Commission, as well as some member governments, are looking at regulatory initiatives, drawing from the experience of France, which introduced ‘Article 173’ requiring investor climate disclosure.

What did the Taskforce recommend?

The Taskforce recommendations are structured around four ‘building blocks’ of Governance, Strategy, Risk Management, and Metrics and Targets.

Within each block there is a core set of recommendations, which apply across both financial and non-financial sectors. In addition, an Annex to the main report sets out specific recommendations tailored to particular sectors.

Financial: Banks, insurance companies, asset managers, asset owners

Non-financial: Energy, transportation, materials and buildings, agriculture, food and forest products

Below we set out the key recommendations for asset owners and managers, highlighting some of the issues involved in implementation.

Core elements of recommended Climate-Related Financial Disclosures



Governance

The organization’s governance around climate-related risks and opportunities

Strategy

The actual and potential impacts of climate-related risks and opportunities on the organization’s businesses, strategy and financial planning

Risk Management

The processes used by the organization to identify, assess and manage climate-related risks

Metrics and Targets

The metrics and targets used to assess and manage relevant climate-related risks and opportunities

Source: Recommendations of the Task Force on Climate-related Financial Disclosures, June 2017

Practical actions for investors: Risk oversight

The **Governance** recommendations emphasize the need for risk oversight by boards and senior management, both by corporations and investors. In the case of investors, the idea is that climate change should be viewed alongside factors such as interest rates and the macroeconomic outlook as a strategic risk, meriting attention by both boards and the CIO or senior investment team.

As a practical action, asset owners should look at tabling an agenda item on climate change at one or more board meetings to review the Taskforce recommendations, and discuss at a high level the likely main sources of climate change risk—and opportunity—faced by the pension scheme. To inform this discussion, it may be useful to look at peer practices, and also to take advantage of work now underway by investor groups, including the Institutional Investors Group on Climate Change and the UN PRI, who are working to inform their members on implementation.

This could then lead on to discussions on **Strategy**, and the range of options available to respond to climate change, within the context of a wider responsible investment approach. These options may include:

- The use of tools and metrics to achieve a greater understanding of risk—covered by Taskforce recommendations
- Active ownership strategies—also covered by Taskforce recommendations
- Divestment or underweighting of high-impact companies
- Positive investment in climate solutions—such as green bonds or equity strategies
- Dialogue with asset managers and peers

Practical actions for investors: Risk analysis and metrics

The **strategy, risk management** and **metrics and targets** sections of the recommendations focus on the question of what methodologies can be used to analyze and mitigate risk, as well as identify opportunity.

Within these, the two key recommendations are on carbon footprinting and scenario analysis.

Carbon footprinting: The Taskforce recommends that both asset owners and managers provide the **weighted-average carbon intensity** for each fund or investment strategy. They acknowledge that this is only likely to be possible for a proportion of total holdings, given that data availability outside of public equities and bonds is very limited.

This was probably the most contentious of all the investor recommendations. As the report itself says, carbon footprinting does not necessarily reflect climate risk. Carbon intensity measures the fossil fuels burned, and electricity used, by investee companies, per dollar of revenue. It does not measure risk and opportunity related to the products and services provided by the company—such as the question of whether a car company is leading or lagging in electric vehicle production. Swings in revenues will change the intensity numbers, even if emissions are stable. And the data, by its nature, is backward-looking historical information.

But as the report also says, it is a simple metric—and with the data we as investors have now, the best we can do if we want to be consistent across a diverse portfolio. We agree with the Taskforce's conclusion that it should be viewed as a 'first step' in the move towards more sophisticated disclosure.

In terms of implementation, we can expect a spectrum of responses: some investors have publicly rejected footprinting approaches, others may choose to footprint only a subset of their portfolio or funds; others will publish more comprehensive data.

Scenario analysis: The Taskforce recommends that investors describe how resilient their strategies are to future climate change scenarios, including one in which governments fulfill the Paris aim of limiting global temperature rise to below 2 degrees Celsius. Asset owners are encouraged to disclose how these scenarios are used in informing investments in specific assets.

The idea of scenario analysis is to tackle the limitations of carbon footprinting. It is forward-looking and risk-focused, with the ultimate aim to get the answer to the question—how will my portfolio perform under different futures for energy and the climate?

However, answering this question is far from straightforward. Methodologies do exist—two examples being the Mercer TRIP modeling framework, which looks at the asset allocation level;¹ and The Two Degrees Investing Initiative,² which analyses on a sector-by-sector basis how aligned companies are to a future energy transition. While these represent significant progress, it is still early days in investors' ability to run robust analysis and understand the investment implications of the results.

The key limitation is corporation disclosure. Data on greenhouse gas emissions by companies is increasingly widely available, though gaps remain, such as in emerging markets. But very few companies publish forward-looking scenario analysis—making it challenging for investors, in turn, to apply scenarios across a wide portfolio.

Practical actions for investors: Active ownership

Investors are expected to be a key part of the solution to this corporation data gap, and have a crucial role to play in pushing for climate-related factors to become part of mainstream financial filings—a prerequisite for ensuring data quality and consistency. The Taskforce specifically recommends disclosure on engagement as part of its investor recommendations around **Risk Management**.

There are two reasons why investor engagement matters in relation to the Taskforce guidance. Firstly, investor engagement is crucial for advancing the adoption of the reporting recommendations. To turn the Taskforce from a voluntary disclosure guidance into a de facto best-practice standard will depend on widespread implementation by a critical mass of companies. Investors will need to make the case to investee companies as well as to regulators and listing bodies, showing that the required transparency is relevant and material to their investment decisions.

Secondly, there will be additional scrutiny on how investors use engagement activities to deepen their understanding of investment risks and opportunities in relation to climate change. The Taskforce recognizes this aspect by highlighting that shareholder engagement with boards and senior management is an important part of building an improved understanding of climate-related risks.

Investors therefore should consider active ownership efforts not only for the purposes of advocacy, but also as an integral part of their risk management practices.

¹ See 'Investing in a Time of Climate Change,' Mercer

² See <http://www.2degrees-investing.org/>, The 2° Investing Initiative

BMO's TCFD-related engagement

As part of our reo engagement program, we have promoted the importance of climate change among corporations and policy makers for many years. Since 2013, we have been involved in increasingly collaborative efforts among investors, asking companies to provide more clarity around their strategies to navigate and support a low carbon energy transition. We have had almost 180 one-to-one or joint investor meetings on climate change since 2015, including programs tailored to companies in the oil and gas, mining, utilities and industrials sectors. TCFD's work provides a useful framework to help coordinate more concerted engagement efforts among investors across markets. As a lead investor within the Institutional Investors Group on Climate Change (IIGCC), we are planning to participate in a global alliance of investors that will engage a broad set of major carbon emitters on their strategies to transition their business plans in line with the 2 degree Paris Agreement targets. We expect this initiative to launch in the second half of 2017.

Conclusion

The Taskforce's recommendations imply significant changes to both the quantity and quality of climate change risk analysis and disclosure for corporations and investors. As such, change will not happen overnight. The Taskforce itself suggests a five-year timescale for full implementation, with monitoring over that time — including a progress report by the Taskforce itself next September, after which it is due to disband.

For investors, there are some recommendations that can be picked up immediately, and others where we will need as an industry to develop new approaches and methodologies. For PRI signatories, the inclusion of TCFD recommendations in the reporting framework is likely to serve as a trigger for disclosure. The gaps in corporation reporting mean that many of the quantitative tools outlined by the Taskforce will have limitations; for fundamental, bottom-up investors, qualitative analysis based on company-specific engagement remains likely to give more investment-relevant information than even the best data tools.

How can BMO help?

BMO has a range of approaches that can help clients address climate change risks and opportunities. For clients in the US, please contact your relationship manager for more information.

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