TCFD: New Publications on Risk Management and Climate Scenarios

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Introduction

With pressure to address climate change continuing to build, there is a growing need for updated and improved guidance on how investors and companies can manage risks and better position themselves for the energy transition. To help meet this, TCFD has significantly increased its output in 2020. This has included new technical guidance on the climate scenario analysis and risk management recommendation. The webinar is aimed to provide signatories the key findings and updated practical guidance on how to implement the Taskforce's recommendation.

Speakers

- **Moderated by: Martin Skancke (MS),** Chair PRI, TCFD Taskforce member
- **Martin Weymann (MW),** Head of sustainability, Emerging & Political Risk Management, Swiss Re, TCFD Taskforce member
- **Jeff Stehm (JS),** TCFD Secretariat

Martin Skancke's Introduction

Martin briefly introduced the TCFD framework. It consists of 11 questions in 4 categories – Governance, Strategy, Risk Management, and Metrics and Targets. TCFD looked at ways to encourage better reporting. People mostly struggle with the last question under the Strategy section of the framework, which is around the discussion of the resilience of the organization's investment strategy under various scenarios, so-called stress-testing. Martin mentioned that Jeff is very knowledgeable with that and central to develop the new guidance that just came a couple weeks ago.

The other challenge, both in the financial sector and non-financial sector is thinking about climate-risk management in the context of the overall risk management. The question in the framework is describing the process for evaluating and managing climate-related risks. It quickly gets into more normative issue – what does the good risk management look like? Martin is very experienced in this and he will discuss this topic in details.

Presentation by Martin Weymann

I. Task Force on Climate-Related Financial Disclosure (Guidance on risk management integration and disclosure) by Martin Weymann

- ***Background***
  - Financial Stability Board created TCFD back in 2017. The recommendation came out in 2017

- The Task Force conducted a survey in late 2018 and found out that 75% of companies surveyed indicated the risk management recommendation is difficult to implement and several of these companies indicated they do not have processes for identifying, assessing, or managing climate-related risks
- Task Force developed risk management guidance in 2020. The guidance is aimed at companies that are interested in integrating climate-related risks into their existing risk management process and disclosing information on their risk management processes in alignment with the TCFD recommendations

- ***Scope and Approach of the Guidance***
    - Applicable for all sectors, all sizes, located in various geographies
    - The Task Force's 2017 report emphasized the importance of disclosing information about climate-related risks ***and*** opportunities. The Risk Management recommendation, however, focuses specifically on climate-related risks.
    - The guidance uses a common risk management language as the foundation for discussing risk management concepts. The guidance drew from COSO's enterprise risk management framework but also meant for use with other risk management frameworks, i.e. ISO31000, or company-specific frameworks and processes.

- ***Unique Characteristics of Climate-Related Risks***
    - At the heart of integrating climate-related risks into existing risk management processes is a solid understanding of the unique characteristics of these risks
    - For companies, this means climate change affect their facilities and operations, supply and distribution chains, employees, and customers
        1) It is important to think about the supply chain of the company
    - The unique characteristics of climate-related risks are summarized below – understanding these is critical to understand how climate-related risks may affect a company
        1) Different effects based on geography and activities: climate-risks occur local, national and global with different implications
        2) Longer time horizons and long-lived effects: climate-related risks may stretch beyond investment and business cycles
        3) Novel and uncertain nature: many of the effects of climate change have no precedent, which makes it hard to analyze based on the historical data
        4) Changing magnitude and non-linear dynamics: possible result in irreversible change
        5) Complex relationships and systemic effects: risks are interconnected across social economical systems
- **Key Principles for Integration**
    - Interconnection: integrating climate-related risks into existing risk management requires analysis and collaboration across the company.
    - Temporal Orientation: climate-related physical and transition risks should be analyzed across short-, medium-, and long-term time frames for operational and strategic planning, which may require extending beyond traditional planning horizons

- Proportionality: the integration of climate-related risks into existing risk management processes should be proportionate in the context of the company's other risks, the materiality of its exposure to climate-related risks, and the implications for the company's strategy
- Consistency: the methodology used to integrate climate-related risks should be used consistently within a company's risk management processes to support clarity on analysis of developments and drivers of change over time

- Initial Steps for Integration
  - Step 1. Understand Climate Change Concepts: ensure there is a general understanding across the company of climate change concepts and its potential impacts
  - Step 2. Identify Processes and Functions: identify the specific risk management processes and elements that may need to be adjusted for the integration of climate-related risk as well as the functions and departments responsible for those processes and elements
  - Step 3. Updated Risk Taxonomy: incorporate climate-related risks into the existing risk taxonomy and risk inventory used in the company. This includes mapping climate-related risks to existing risk categories and types
  - Step 4. Adjust Risk Management Elements: adapt existing risk management processes and key elements based on information gained in the previous steps and the characteristics of climate-related risk

- Disclosures of Risk Management Process
  - Disclosures should be ***presented in sufficient detail*** to enable users to assess the company's exposure and approach to addressing climate-related issues
  - Taking into account and addressing the different time frames and types of impacts
  - A company's reporting should provide a thorough overview of its exposures to potential climate-related impacts
  - Disclosures should be written with the objective of ***communicating financial information*** that serves the needs of a range of financial sector users. The disclosures should be ***sufficiently granular*** to inform sophisticated users but should also provide concise information for those who are less specialized
  - Balance between qualitative and quantitative information
  - Changes in disclosures and related approaches or formats can be expected due to the relative immaturity of climate-related disclosures. ***Such change should be explained***

Q&A with MW

- Question by MS: Ask MW for the practical examples. Just think about your experience at Swiss Re -what is your main take-aways in doing this internally?
  - Physical climate-related risks is something for insurance company has a long tradition, when it came to natural catastrophe and for events that have climate risks. 150 years we have developed over time to models we are fully integrated into integrated risk models in the group level

    - Newer exposures that are more relevant from earnings perspective - these are the things we are able to integrate to the existing model
    - Transition risks, that we started a couple of years ago, but still a lot to do further
    - Short, medium, long-term horizon, physical risks that are controllable in the short term, but in the long time need to think about different scenarios might come up
    - Transition risks will definitely affect the asset side. Need to be well prepared the opportunities to accelerate the transition

- MS: You have stressed on thinking cross-organizationally. What kind of themes did you put together to get a holistic view of climate risk in your organization?
    - Importance there is to have a broad coverage. Think we all have different education background, different regional experience represented. Also there is catastrophe, there is risk on the asset management side, on the liability side, just need to have a broad coverage
    - Swiss Re also has an emerging risk process which we tackle every risk quarterly. we bring up a new risk exposure quarterly and see how we tackle them

- MS: Obviously Swiss Re is a big company and has many resources. What is your advice for smaller companies, companies with limited resources who just start off the journey here, how can they start in a small way?
    - First step, do a risk landscaping to materialize risk. At Swiss Re, the first step is also always brainstorming to identify what the 3-5 biggest factors of climate change are and can affect balance sheet. Do the mapping before doing any modeling
    - Very important before doing scenario analysis as well because you did materializing risks to see how it can not only affect balance sheet, but also affect strategy in the short-term, medium-term, and long-term

- MS: Central part of risk management is to define the risk tolerance. How do you think about this issue at Swiss Re? How do you think about quantifying risk tolerance for climate-related risks and castigating it down to different business units?
    - On the one hand, defining on the qualitative level - identify risk appetite when you define certain thresholds
    - When to define risk appetite - how to define risk in the insurance and reinsurance line of business, and in certain asset class, make sure that define at the group level, triple down to business units and single units of those business units. That's more quantifiable look – you set certain limits
    - Combination of both qualitative and quantitative approaches, you have overall as quantitative and each qualitative. For example, we think about reducing certain exposures in the certain sector, writing more business to help, what at Swiss Re, called "protection cap insurance", it is the cap of insured values and the potential economic losses
    - In terms of transition risk, we want to support accelerating transition work in order to support technology development

Presentation by Jeff Stehm

- ***Why did the TCFD issue scenario guidance?***
  - Around 1700 companies conducted review, only 7% of companies disclose information about the resilience of their strategy
  - Companies express three groups of challenges they face. The challenges are summarized as below:
    1) First challenge is implementation challenge around scenario analysis, such as complexity, uncertainty in assessing climate risks, lack of sufficient data and resources
    2) Second, how to apply scenario on how to develop resilience strategy, how to express the characteristics of the resilience strategy
    3) Third challenge is concerning disclosures: what information disclosed demonstrate the credibility of the scenario analysis. Barriers around business confidentiality and concerns about forward-looking information

- ***In response.. The TCFD's issued new scenario guidance***
  - How to get organized, the scenario process, strategic management and disclosure
  - In addition, there are 4 supplementary appendixes and practical models and examples on IPCC and IEA and how they ca be used
  - Financial firms may find value in the guidance

- ***There are 4 key themes in the guidance***
  - <u>Scenario analysis is not new or difficult:</u> Its been around for a long time, have been successfully implemented by many companies and doesn't require extensive resources
  - <u>It is useful tool for informing strategic management under conditions of uncertainty:</u> provide insights to the questions such as what are the potential implications if future described in the scenarios is going to pass, the key drivers of climate-risk related opportunities, and what uncertainty may affect how these drivers play out in the future
  - <u>It can enhance strategy resilience:</u> providing new perspectives and insights
  - It is an important aspect of a company's disclosures to demonstrate resilience and inform investors

- ***Four steps***
  - <u>Step 1 - Getting organized:</u> informing, educating and engaging internal stakeholders in the company, building a case for scenarios, and establishing a clear governance structure and process for scenario analysis including explicit executive-level sponsorship and C-suite support is absolutely critical
  - <u>Step 2- Developing scenarios:</u>
    1) Formulate a concise focus and scope for scenario analysis
    2) Company needs to identify forces driving those changes and identify critical uncertainties
    3) Two to four plausible scenarios need to be constructed. Allow companies how different assumptions can yield very different outcomes

    ***Among those steps, engaging internal stakeholders across the firm is key**

- <u>Step 3 – Applying scenarios to strategy:</u> a key objective of scenario analysis is to assist in producing a more resilient corporate strategy to plausible climate futures. The guidance talks about scenario analysis contributing to formulating a more resilient strategy in four ways:
    1) By broadening strategic thinking about plausible futures
    2) Improving the range of options companies considers
    3) Reduce the likelihood of surprises
    4) Providing a process for exploring alternatives
    - The power of scenario analysis starts with the simple question how would your company's existing or proposed strategy likely perform under each scenario if it were true?

- <u>Step 4 – Appropriate disclosure is essential:</u> investors and other stakeholders, fundamentally, want to understand how a company plans to address climate risks and opportunities in its strategy and financial plans
    - Effective disclosure should discuss, at a minimum:
        - How scenario analysis was structured and used
        - What changes the companies has made to its strategy in response to the scenario analysis?
        - Where the uncertainties are regarding the company's strategy?
        - What are the potential financial implications of the company's strategy?

JS recommend everyone to go to the TCFD website to look at the full guidance.

Q&A moderated by MS

- Question by MS: just want to clarify, you mentioned that this is mainly written for non-financial companies? Are there any elements relevant for financials?
    - JS: Reporting in undertaking of scenarios of non-financial is critical for the analysis for the financials that investors do. So it is important for the non-financial sector to get started
    - Financial institutions have a history of stress-testing their portfolio so they understand at least some of these
    - TCFD make two determinations: 1) focus on the non-financials as area of greatest need currently with understanding financials has background of stress-testing, 2) there was a number of initiatives in 2020 among financial firms/regulators to extend stress-testing. TCFD wanted to take a look at how those efforts and what directors they are taking before issuing any guidance
    - It is important for financial firms to educate themselves how to interpret and engage with non-financials on scenario analysis process

- Question by MS: MS acknowledge that JS' last point is very important as we see those stress-testing is often the start of the engagement process of capital allocation for companies. Question to MW - risk management is really related to the scenario analysis, stress-testing and understanding the resilient of the business model. To what extent would you say that is the general guidance of the scenario that you can use in financial company, even though it is mainly written for non-financials company?

  - MW: there is great material which can absolutely used for financials company. Scenario analysis should start with thinking in a qualitative way before quantifying it. Scenario analysis is most valuable for discovering 1) understand risk management in more details, 2) discovering business opportunities. In this regard, what JS presented is useful for financials sector
  - Stress-testing: stress-test the sudden change in the climate system is happening which is a more traditional way. For example, how does the introduction of carbon price affect the asset prices. Whereas scenario analysis is a broad concept which help really test the strategy in a more qualitative way.

- MS: this leads to the third question which is the purpose of doing the scenario analysis is not to produce a report. Where according to MW is more a interim process which you have this as a part of the strategy process you use it to test the business models to test against the future outcomes.
  - MW: agreed
  - JS: echo that many companies treated scenario analysis as a process, something want to integrate in the heart and soul of the internal strategy process. It is important companies approach it keeping this mindset

- Where can you get good examples to learn good practices?
  - JS: couple of sources. 1) <u>WBCSD TCFD forums.</u> They have done five sectors and issue the reports on five sectors; 2) <u>TCFD also operates a knowledge hub</u>; 3) <u>two or three different companies done some case studies in the guidance that issued in October.</u> That is also where you can see how companies tackle the scenario analysis
  - MS added that there are more case studies on financials sector in the PRI website on PRI signatories

- How can regulators encourage companies to undertake more scenario analysis? Keep in mind that the whole initiative for the TCFD coming from the financial stability board – so it was originally from a systemic regulatory point of view
  - JS: TCFD is a voluntary framework- it is industry-led. There has been tremendous work by the financial sector, stress-testing.
  - A group of central banks to look at scenarios, might be used by central bank in different ways. As they learn and improve their models and thinking, central bank looks at the financial system, it will gradually evolve into have banks apply some of the principles in the micro basis in their stress-testing
  - MS: there are discussions on whether TCFD should be voluntary. Should it be supported by legislators? The disclosure requirements might force you into doing something, is that true?
    - JS: Yes, this is very true. Considering TCFD is a voluntary framework, TCFD is not actively trying to get this mandated. The position of TCFD is that we don't want

to see fragmentation across jurisdictions in terms of the approaches and the frameworks being used. We would want regulators to coalesce around the TCFD framework as the basis of mandatory regulations going forward
        - MW: creating consistency around jurisdiction matter. It is not the role of TCFD to make it a mandatory role

- MS: Jeff, you role in TCFD is so essential. So what can we expect in next year in terms of publications, guidance and etc from TCFD?
    - JS: TCFD is deliberating where they want to go. A few areas that we have not focused on, is
        - Asset managers and asset owners
        - Financial impact: how companies can disclose the financial impact around those climate risks. These two are likely to be the focus going forward
    - There are also methodology questions, metrics question that TCFD is trying to take a look at

- MS: There are many signatories watching this, PRI is trying to assist signatories make sense of this. PRI is working along two tracks:
    - Try to help signatories make sense of and use in a constructive way the reporting they get from the companies they invested in
    - Second, assist signatories understand what good reporting from our signatories would look like to their stakeholders

MS ended the presentation by reminding everyone PRI just released reporting and assessment framework

– END –