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Is climate related risk a real risk to the future prospects of business?

Sustainability is known as a business sector laden with ever growing lists of jargon and acronyms, well, it's time add another. TCFD is the latest must know acronym used to describe the **Taskforce for Climate-Related Financial Disclosures.** But what is it? If that's the first question that sprung to your mind then don't worry, you are not alone. A survey conducted by HSBC in 2017 found that only 8% of big companies and 10% of investors were familiar with the term.

What is TCFD?

The TCFD has its roots in a speech given by Mark Carney in 2015 where he discussed the "...tragedy of the horizon..." in relation to the potential risk posed by climate change to global financial stability.

These risks fall into three broad categories:

1. Physical Risks, relating to the direct impacts of extreme weather events on business as usual;
2. Transitional Risks, relating to the aspects of business most likely to be impacted by the move to a low carbon economy. Includes the concept of stranded assets for example, remaining fossil fuel reserves unable to be burned wiping value off the holding entity; and,
3. Liability Risks, relating to action taken against companies who continued to profit from polluting activities despite being fully aware of their impact on the climate.

The Financial Stability Board (FSB) launched the TCFD in 2016 seeking to develop recommendations for voluntary climate-related financial disclosures that are consistent, comparable, reliable, clear, and efficient, and provide decision-useful information to lenders, insurers, and investors.

In order to comply with the scheme, organisations needed to disclose how they were addressing the risk posed by climate change to their business models in four key areas:

Governance	Disclose the organisation's governance around climate-related risks and opportunities.
Strategy	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning where such information is material.

Risk Management	Disclose how the organisation identifies, assesses, and manages climate-related risks.
Metrics and Targets	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.

Why is it important?

TCFD is widely regarded as being a "gamechanger" with regard to how businesses account for and mitigate climate risk. Perhaps crucially this is not another sustainability standard. TCFD represents a shift in emphasis from reporting only on sustainability metrics, such as energy efficiency or landfill waste reduction, to financial disclosures, such as the impact of carbon regulation to consumer demand for a company's products, or the supply chain disruptions likely to occur from severe weather events.

The reporting process is a Board responsibility and disclosures are made within financial filings as opposed to being included as part of a company's sustainability reporting. The focus has also been shifted by the TCFD to ensure companies report on climate change impacts on them as opposed to their contribution to global emissions. What is, arguably, most interesting is the requirement for businesses to plan for the long term, possibly over horizons of 30 years or more in the UK at least given the UK Government's decarbonisation targets set out in the Climate Change Act.

By forcing companies to disclose the risk to their long term profitability under a range of climate scenarios, pro-environmental behaviours become far more likely. Sunlight, after all, is the greatest disinfectant.

Is TCFD mandatory?

The short answer is no, TCFD is a voluntary disclosure. However, the more companies that sign up in support of the scheme, the more it becomes a market imperative. 390 companies had given their support to the scheme by August 2018, including numerous Real Estate and Asset Management companies.

Placing TCFD to one side, the Companies Act 2006 requires companies' strategic reports to "...describe the principal risks the entity faces and how they might affect its future prospects…". To paraphrase the environmental law group ClientEarth, "...if climate change isn't a principal risk to an entity's future prospects, then what the hell is?"

In addition, debates around the definition of fiduciary responsibility to take greater account of securing long term returns in light of the existential threat posed by climate change have already led to pension reform in the UK to

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ensure fund managers report on climate risk where it poses financially material risks to the fund. This has, of course, led to nervousness among some investors who see direct conflict between securing short term vs long term returns, between creating and destroying value.

How does it relate to Real Estate?

The Real Estate sector is directly impacted by physical and transitional risks brought by climate change.

Discussions have been had for a long time now regarding the risks to property posed by the increasing frequency and severity of acute weather events. These have been focussed principally on flood risk, linked in turn to insurance risk. But with 2018's summer heatwave fresh in our minds we saw a glimpse of how buildings might cope, or not, with sustained temperatures beyond their designed cooling capacities; how infrastructure struggled to maintain key commuter flows; and how moorland fires restricted people's ability to even leave their homes.

Scenario modelling of likely climate change this century suggests the Paris targets of 1.5° of warming are likely to be passed, with 3-4° conceivable. At these levels the current models of insurance would no longer be viable as the risks become too high, further, these are global average rises. Areas of the globe most vulnerable would see greater impacts meaning property risk in those areas would effectively render those assets worthless.

Energy and water efficiency is another key issue in buildings, and one that is already influencing investment decisions against the backdrop of a transition to a low carbon economy. Inefficiency is a sign of vulnerability to price shocks in the utilities commodity markets, and of viability as water stress in more populous areas impacts the ongoing supply.

Adopting the recommendations of the TCFD enables Real Estate businesses to assess the risks to their longevity and make plans to mitigate those risks and adapt their business model.

To discuss any of these, or other issues, please contact Carl Brooks. carl.brooks@mjmapp.com