TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

GOVERNANCE

What Does *Good* Look Like?

Introduction

THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES (TCFD) CENTERS ON FOUR PILLARS – GOVERNANCE, STRATEGY, RISK MANAGEMENT, AND METRICS AND TARGETS. THESE PILLARS INCLUDE 11 MORE SPECIFIC RECOMMENDED DISCLOSURES THAT PROVIDE A HOLISTIC FRAMEWORK AGAINST WHICH AN ORGANIZATION'S CLIMATE RESPONSE CAN BE JUDGED.

Although conceived to support capital markets, the TCFD is useful for any organization that wants to develop its thinking and response to climate-related risks and opportunities. However, it can be challenging to understand what "good" TCFD alignment really means. It's easy to get trapped by details, or confused by rapidly changing science and the expansive literature now available.

This paper, which focuses on the governance pillar of the TCFD, cuts through the noise and simplifies insights to help organizations get started or move forward on their climate journey. It unpacks the meaning and intent of climate governance, identifies real-world examples of "good", and provides take-home messages to help you guide your way.[1]

We begin with governance because the effect of good (and bad) climate governance cascades through an organization. Wherever you are on your climate journey, it's critical to get governance right. We hope this resource will help you to do so.

If you have comments, queries or suggestions for future topics, please contact us here.

[1] The analysis in this paper is based on our own work, with additional data on disclosures derived from the TCFD's latest status report (2021), which you can get here.

Conceptualizing the TCFD

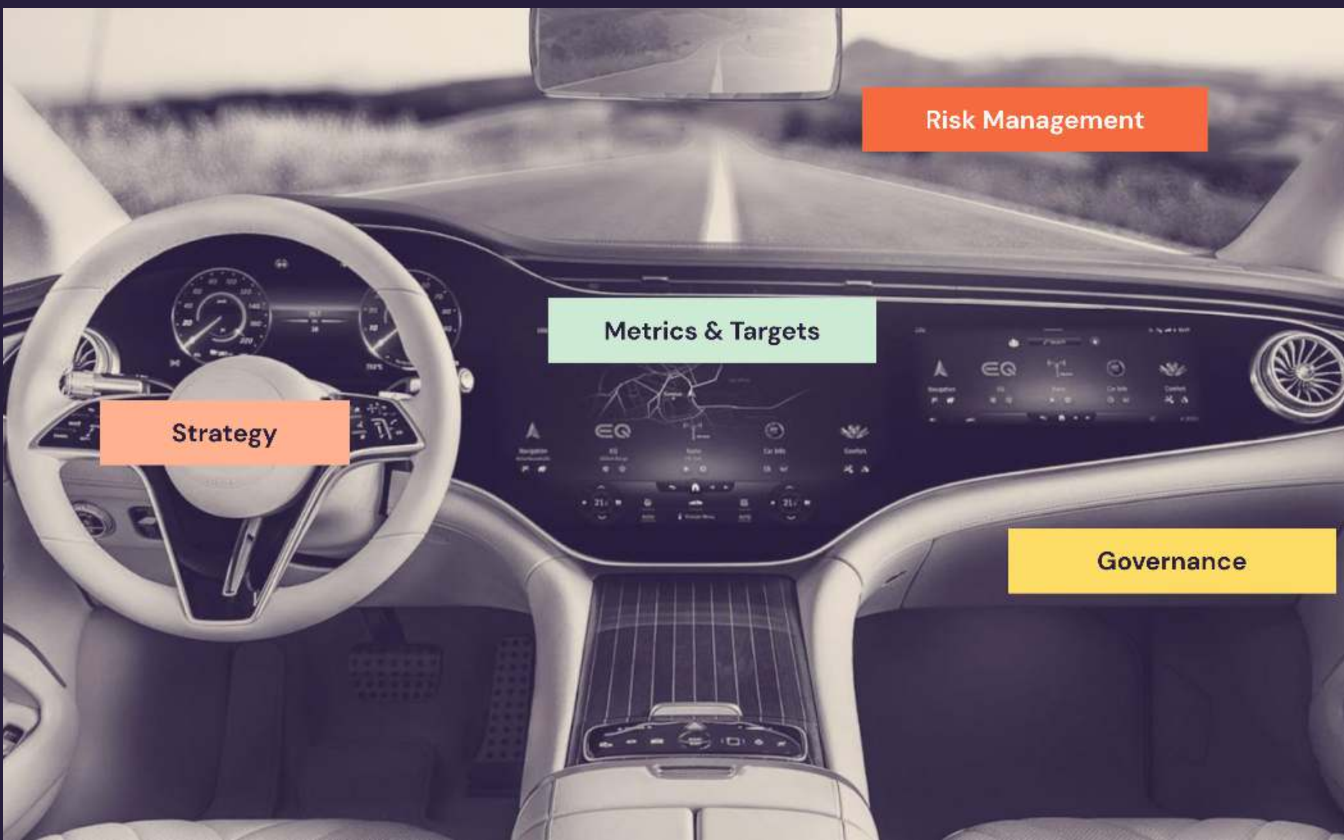
It can be difficult for newcomers to the TCFD to conceptualize how the four pillars of the TCFD work together. To help out, you can think about the four pillars as the cockpit of a car.

The governance pillar of the TCFD is like the operating manual of a car – typically found in the glovebox – that describes the processes and procedures needed to understand how the car should run, and what to do to troubleshoot issues that come up.

The strategy pillar describes the climate direction of the organization. It asks where the business is going. And direction is a crucial part of the TCFD – it's forward-looking. In the cockpit of a car, that's the steering wheel.

Risk management is the pillar that helps you identify risks. That's a bit like the rear-view mirror or, in modern cars, a forward-looking radar scouting for obstacles.

Finally, the metrics and targets pillar of the TCFD is the data and information that reflects your greenhouse gas emissions and the targets you might set for them, among other elements. In a car, that type of information might be found in the gauge cluster or central monitoring systems. So, when you think metrics and targets, think monitoring systems.



Overview

THE GOVERNANCE PILLAR OF THE TCFD, WHICH CONSISTS OF TWO RECOMMENDED DISCLOSURES, IS DESIGNED TO ALLOW THOSE INTERESTED IN A COMPANY'S FUTURE (E.G. INVESTORS, LENDERS, INSURERS, ETC.) TO UNDERSTAND WHETHER ITS BOARD AND MANAGEMENT ARE PAYING SUFFICIENT ATTENTION TO CLIMATE CHANGE.

Recommended Governance Disclosures

Governance A – Describe the board's oversight of climate-related risks and opportunities

Governance B – Describe management's role in assessing and managing climate-related risks and opportunities

Don't be misled by the fact that there are only two recommended disclosures (each of the other pillars has three), or by the apparent simplicity of Governance A and Governance B.

An organization that gets climate governance wrong almost invariably makes bad decisions on climate strategy, risk management and metrics and targets.

Conversely, an organization with good climate governance is typically able to unlock the power of a good climate strategy, proactive risk management and behavior-changing metrics and targets.

Governance is central to determining how well prepared an organization is to cope with the impacts of, and the organization's impact on, climate change.

Driving The Bus

Comparing a business to a bus has a long history, both in management consulting and in law. That comparison often sees business leaders as bus drivers, but it's more nuanced than that in practice. The leadership of a business is almost always more than a one-person affair. So - for the metaphor to work - we have to recognize the different roles that the board and management play.

For TCFD purposes, you can think of a company as a bus, but with climate leadership coming from both the board and managers. It's impossible for everyone on the leadership team to drive the bus, so it falls to governance processes to assign individual responsibilities. Taking this further, the board should always set the destination (i.e. have overall responsibility for the company's climate response), but the managers must be empowered to make the directional changes necessary to reach that destination. That's why the governance pillar is split into two parts: Governance A, and Governance B.

Governance in Practice

UNFORTUNATELY, MANY ORGANIZATIONS POORLY DISCLOSE HOW CLIMATE CONSIDERATIONS PLAY INTO THEIR GOVERNANCE PROCESSES. THE TCFD'S LATEST STATUS REPORT RECORDS THAT THE TWO RECOMMENDED DISCLOSURES OF THE GOVERNANCE PILLAR REMAIN THE SECOND AND THIRD LEAST DISCLOSED, RELATIVE TO OTHER TCFD RECOMMENDATIONS.

In some respects, this lack of transparency is a remarkable finding. But when you look closer, it's understandable, for two reasons:

First, disclosing your governance processes is a bit like disclosing the workings in your math problem. In a math test, a wrong answer may attract criticism, but the student's granular disclosure of their approach may unwittingly highlight a degree of ignorance to the problem that might warrant extensive remedial work. Unfortunately, unlike your math class, when showing your approach is encouraged to allow additional and meaningful coaching, the real world of governance is less forgiving. Rightly or wrongly (and the answer should be wrongly), a company that details its working (i.e. provides transparency on its governance processes) may attract adverse and, perhaps, legal, scrutiny or risk stakeholder pressure, including investor pressure.

Second, governance covers a lot of ground, ground that is fundamental to the whole organization. It takes time to get it right, and – more than ever – it often involves competing interests.

Historically, directors had a relatively simple job. For centuries (literally), a board could focus on maximizing profit, at the expense of almost everything else. The law did struggled with deciding whether directors owed their duties to shareholders or the company, but generally, if a company generated good returns, the board was seen as functioning well.

Today, the picture is more complex. Although most jurisdictions include a clear statement of principle – that directors must act in the best interests of the company – many boards still struggle when it comes to climate change.

This is partly due to the fact that companies are a legal fiction, so to speak of them having "best interests" is nonsensical. To return to our bus metaphor, to say that directors must act in the best interests of a company offers no more guidance to directors than to instruct a bus driver to act in the best interests of a bus[2]. For that reason, the best interests of a company are commonly determined by reference to the stakeholders of that company (akin to the passengers of the bus), not by reference to a fictional person or vehicle.[3]

Sadly, our bus metaphor starts to break down as the number and variety of stakeholders becomes more complex. It's one thing to think about stakeholders (passengers on a bus) as employees, creditors and a residual group of claimants called shareholders – a group of well-defined individuals. It's quite another to think of an undefined set of stakeholders called consumers, the government or the atmosphere. In practice, today's directors are often asked to reconcile dissimilar and often competing interests, which demands an extraordinary effort.

On New Zealand's North Island, the Whanganui River is an important natural resource and one that, in 2017, was recognized as a legal person. That extension of legal rights commands attention; the river becomes, in effect, an increasingly vocal stakeholder for those along its banks.

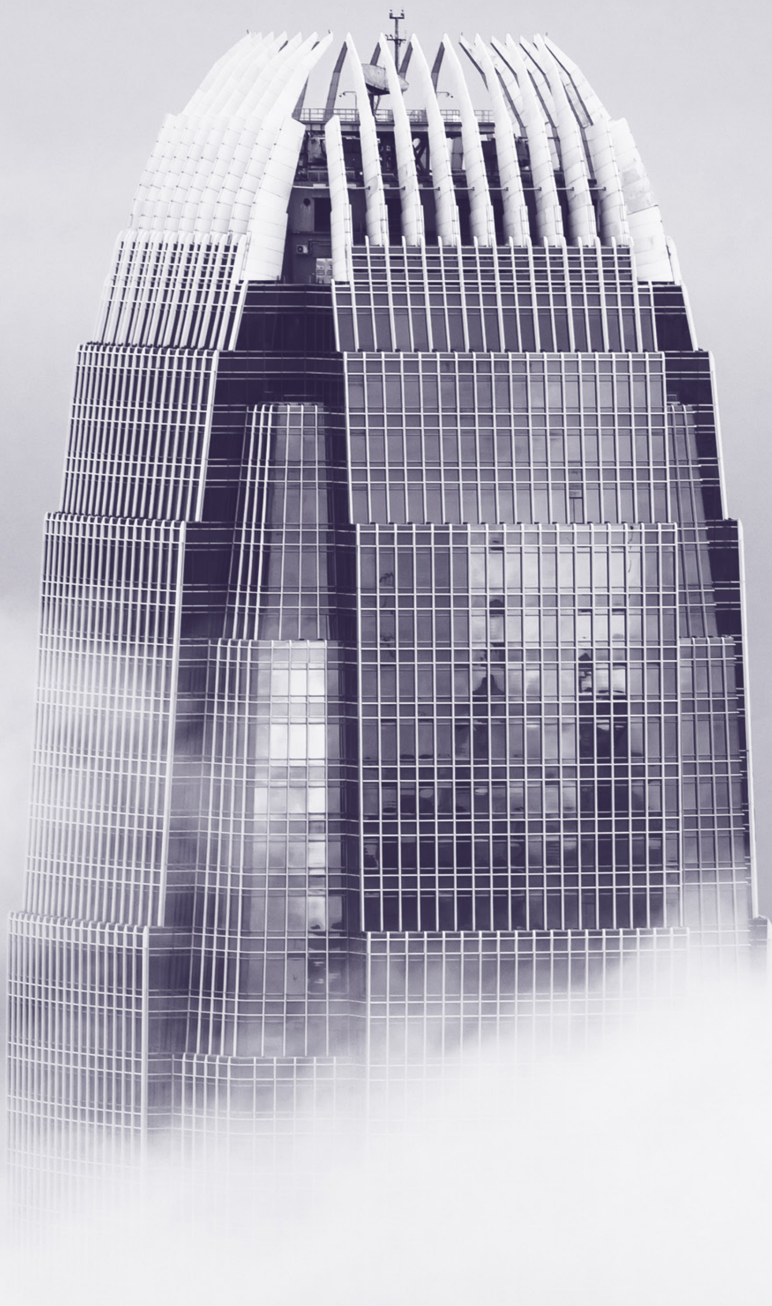
[2] In Canada this sentiment was memorably stated by jurist E. Iacobucci, "Indeterminacy and the Canadian Supreme Court's Approach to Corporate Fiduciary Duties" (2009), 78 Can. Bus. L.J. 232; pp 236.
[3] *Ibid.*

A director's job is made even harder because their decisions are not made in a vacuum; they are made in a fiercely competitive and dynamic environment. A company that publicly discloses a poor governance process, even if it is a process that is widely adopted in the industry, may be put at a competitive disadvantage vis-à-vis others remaining silent. For some, that is too great a risk.

Whether it's difficult or not, it's increasingly clear that adopting a mute, self-interested, or ostrich approach to climate governance is a poor survival strategy. Put differently, boards must pay attention to climate change. That means every strategic decision should include a climate lens. And they should disclose how that's happening.

The extent to which a climate lens will actually change an organizational decision depends on the issue. And the extent to which a board feels compelled to daylight its processes remains – until such time as disclosures on climate governance become mandatory[4] – a discretion of the organization.

The good news is that boards are waking up. And external pressure is mounting on them too. This may explain the uptick in governance disclosures in the last 24 months. The state of play is still not great, but there is positive momentum.



[4] In a number of jurisdictions mandatory requirements to disclose climate governance are already in place, for example, in New Zealand (see here) and in the UK (see here).

GOVERNANCE A

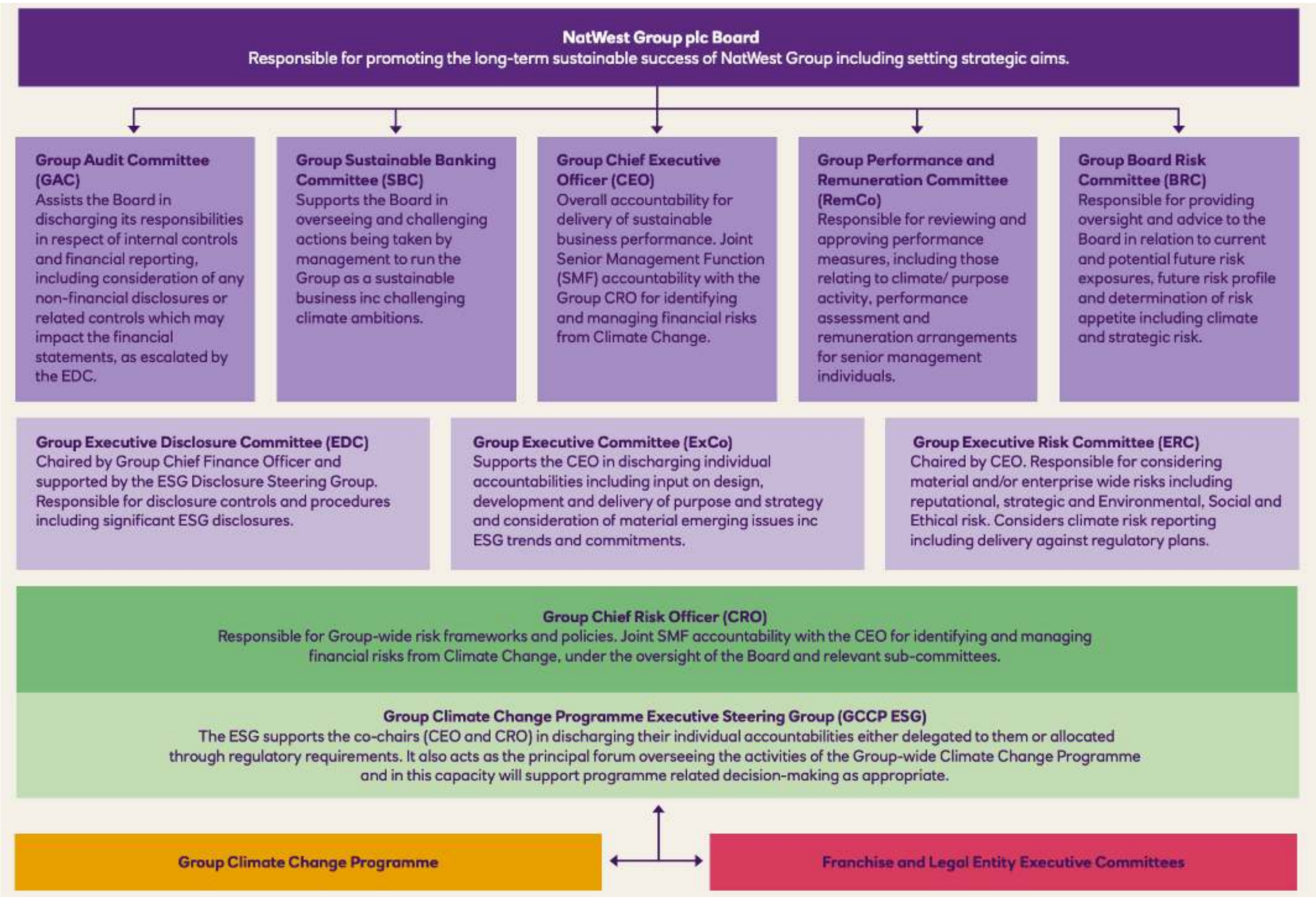
What Does Good Look Like?

A good approach to Governance A requires a high level of transparency, illustrating, among other things:

- the process and the cadence by which the board and its committees are informed about climate-related matters;
- the extent to which climate is integrated into the board's responsibilities, and
- the processes, if any, that are in place to support the board's monitoring of key initiatives and any climate-related targets set by the company.

Governance A addresses the board directly, i.e., the group of people within an organization who are entrusted with significant influence and who, by virtue of that trust, must also bear the greatest responsibility. Governance A is really about understanding the extent to which board members are aware of, understand, and act on the impact of climate risks and opportunities.

Let's take a look at an example from the National Westminster Bank's Governance A disclosure:



GOVERNANCE A

There's a lot to like about NatWest's disclosure, which is fully described in its Climate-related Disclosures Report 2020 (p. 30). The structure clearly identifies:

- Board structure, its committees and the climate-related topics over which these committees have oversight. The disclosure also clearly identifies the functions of these committees, how they fit into overall firm governance and who chairs certain committees (e.g. the CFO chairing the Group Executive Disclosure Committee).
- Level of board oversight on climate-related topics such as risk management, disclosure, and strategy, among others.
- Timeline of meetings in 2020 for different Board committees.
- Climate competency of the Board.

Our Takeaway

Be specific and complete, yet succinct.

A good disclosure for Governance A (and a good approach to climate disclosures more generally) should demonstrate climate leadership at the very top of the organization. Good disclosures also provide the detail that is necessary, i.e. who has overall responsibility, how frequently the board is updated, and what committees and other individuals are involved. Beyond that, while it's helpful to provide some additional detail on the extent to which individuals or committees have delegated responsibility, it's not necessary to provide a treatise. Not only will your lawyers thank you (see our analysis above), so too will the readers of your disclosures. In our work, we can build a very good picture of how well a board is overseeing climate matters by asking very few questions (five, to be exact).

GOVERNANCE B

What Does Good Look Like?

Governance B is focused on the answer to three questions:

1. Who at the management (non-board) level has climate responsibilities?
2. Are there processes in place to inform and help management monitor climate-related issues?
3. What degree of climate expertise does management have access to?

In other words, it is not enough for the board to assume overall responsibility for climate matters. A climate-responsible company must demonstrate how its managers help to oversee and carry out climate-related projects, manage climate-related processes and further the integration of climate across the organization. Those managers will ultimately report to the board, but they should have the autonomy and authority to bear a fair share of the climate burden.

Let's take a look at BNP Paribas (BNP) for an example.

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GOVERNANCE OF CLIMATE RELATED ISSUES

MANAGEMENT IS RESPONSIBLE FOR ASSESSING AND MANAGING CLIMATE RELATED RISKS AND OPPORTUNITIES

The strategic climate objectives set by the Board of Directors are operationally implemented across the Group by the entire Management structure:

- The executive corporate officers[7] determine the Group's climate policy and oversees its performance;
- The Company Engagement Department and the CSR Department are in charge of implementing the Group's climate strategy;
- Dedicated CSR teams and a network of CSR officers roll out climate related policies at all Group entities;
- The operational entities and the Risk Function (RISK) are responsible for managing risks, including climate related risks;
- The compensation granted to key employees of BNP Paribas is indexed in part to the Group's CSR performance data, related to energy and climate related issues.

GOVERNANCE B

Here's what we like about BNP's disclosure, which you can find in full in its TCFD Report 2020 (p. 9):

- It clearly identifies the roles responsible for developing and implementing the firm's climate strategy.
- It details the teams working on climate-related topics within the firm, the work completed in 2020, and how this is tied to the firm's climate strategy, as well as managerial oversight of this work.
- It identifies the areas of expertise of the leaders on its CSR team.

Our Takeaway

Structure your Governance A and Governance B disclosures so that, read together, they clearly articulate who does what (responsibility), who tells who what (communication), and who makes what decision (oversight).

Governance B should not be read in isolation. Rather, it should dovetail with and complement Governance A. If, after developing your disclosures on Governance A and B, the picture remains fuzzy as to responsibility, communication and oversight of climate matters, you still have work to do. Conversely, if your Governance A and Governance B disclosures allow readers to frame a clear, consistent and comprehensible picture of your climate governance, then you're ready to move to the second pillar of the TCFD: Strategy.

Conclusion

THE TCFD CAN, ON FIRST LOOK, BE OVERWHELMING. THE EXPLANATIONS, TAKE-HOME MESSAGES AND EXAMPLES OF "GOOD" IN THIS PAPER ARE DESIGNED TO GIVE YOU A HEAD START.

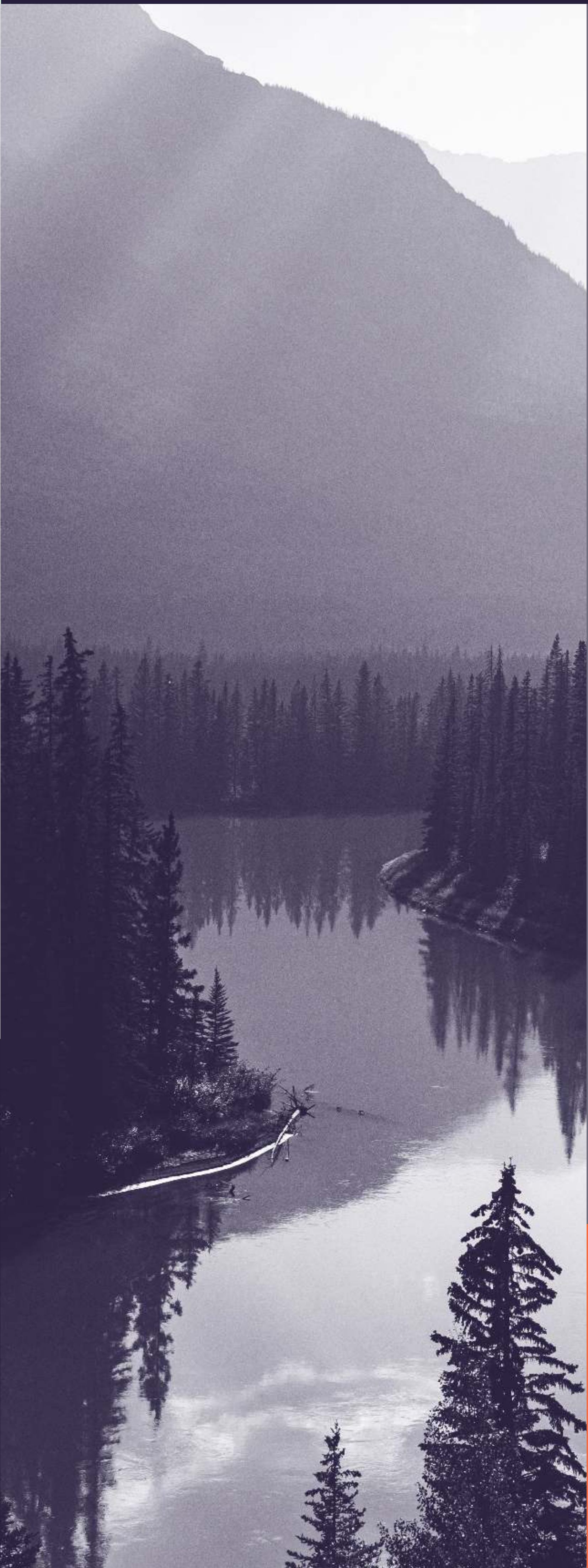
You'll need more of course, e.g. you'll need to understand how, where, and when to publish your climate-related disclosures (spoiler alert: in mainstream financial filings, at least annually, for governance), but getting to grips with the basics – illustrated in this paper – is an early marker of success.

It's important to remember that it takes time to get the most out of the TCFD recommendations. Returning to our car metaphor, just because the TCFD has provided a great dashboard (framework), doesn't mean that every person (company) using it is a great driver. It takes time and effort to hone and practice TCFD skills, just as it takes time and effort to become safe behind the wheel of a car.

For that reason, a (simple) key message we give to our customers is to "get started". Mandatory TCFD-reporting is accelerating around the world, which is one reason for businesses to be prepared. But there's a more fundamental reason to get going; good climate stewardship is just good business (download our previous white paper for reasons why this is the case).

In this paper we looked at governance, which is key to unlocking the power of the TCFD; governance sets up the processes needed to turn climate risks into opportunities. Look out for publications covering strategy, risk management and metrics and targets, which are coming up soon.

If you have comments, queries or suggestions on this paper, please contact us here.



MANIFEST CLIMATE

TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

GOVERNACE

What Does *Good* Look Like?

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