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Climate-related metrics, targets, and transition plans: TCFD proposed guidance

The FSB states that it established the TCFD “to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit, and insurance underwriting decisions and enable stakeholders to understand better the concentrations of carbon-related assets in the financial sector and the financial system’s exposures to climate-related risks.” It is a voluntary framework of recommendations that applies to the financial sector (banks, insurance companies, asset managers, and asset owners) and some nonfinancial sectors (energy; transportation; material and buildings; and agriculture, food and forest products), including some sector specific guidance. In its recent request for public input on climate-related disclosures, the SEC queried whether it would be advantageous for the agency to incorporate or to draw on existing frameworks such as the TCFD when developing its own requirements. In May, President Biden signed an Executive Order on Climate-Related Financial Risk that directs federal financial agencies to develop, and execute on, a strategy to quantify, disclose, and mitigate financial risk of climate change on assets held by both public and private entities. The order requires the members of the Financial Stability Oversight Council to make recommendations to incorporate climate-related financial risk mitigation into regulatory and supervisory practices.

Key points

- TCFD is proposing general guidance for organizations seeking to establish metrics, targets, and transition plans around climate related risks and opportunities.
- Updates to earlier TCFD guidance are intended to reflect the evolving nature of climate-related financial reporting, including new data for metrics and disclosures, increasing demand from stakeholders, calls for comparability and standardization, and commitments by organizations and jurisdictions to achieve net-zero emissions.
- Seven metrics are proposed for disclosure by all financial and nonfinancial sectors; additional proposals for financial institutions would expand guidance around carbon-related asset metrics and provide new guidance on forward-looking metrics, including portfolio alignment metrics.
- TCFD is seeking public comment on the potential usefulness of the climate-related metrics in promoting comparability across financial disclosures.

The Financial Stability Board’s (FSB) Task Force on Climate-related Financial Disclosures (TCFD) has released two documents for consultation that are intended to update portions of the TCFD’s Final Report on recommendations for climate-related financial disclosures and the accompanying Annex to that Final
Report, both of which were released in 2017. The TCFD notes that the use of disclosures by financial and nonfinancial organizations has continued to progress since 2017 as the result of market and industry developments, including advances related to metrics for transition risk (such as Scope 3 emissions), increased investor and stakeholder pressure for climate-related metrics and targets, commitments by organizations and jurisdictions to reduce greenhouse gas (GHG) emissions, and coordinated efforts by global standards setters to achieve convergence. In response, the TCFD has issued:

— Proposed Guidance on Climate-related Metrics, Targets, and Transition Plans
— Measuring Portfolio Alignment: Technical Supplement

Comments on the consultations, including answers to specific questions, will be accepted through July 7, 2021. Final documents are expected to be released in the fall of 2021.

A brief outline of the proposals follows. Notably, the materials include numerous detailed charts, callouts, and appendices that serve to illustrate the proposed guidance; the TCFD also references many of its reports and consultations in addition to those linked above.

Climate-related Metrics, Targets, and Transition Plans

The proposed guidance is intended to provide general guidance to organizations seeking to establish climate-related metrics, targets, and transition plans around climate-related risks and opportunities as well as to propose certain specific changes to the 2017 Final Report and Annex.

Metrics

In general:

— Six fundamental principles should apply to the selection of climate-related metrics. Metrics should be: i) decision useful (relevant to the organization’s risks and opportunities); ii) understandable (including limitations, context); iii) verifiable; iv) objective; v) trackable over time (and disclosed consistently from year to year); and vi) aligned to other TCFD pillars (and linked to processes for governance, strategy, and risk management).

— Organizations should consider integrating climate-related metrics and financial impacts with other disclosures on company risks, financial effects, and outlook. Further, each of the metrics and financial impacts should be disclosed for historical, current, and forward-looking periods, if relevant.

— Communication and disclosure of climate-related metrics, financial impacts, and associated contextual and supporting information should include the:
  — Type of measurements used, such as direct measurement, proxy indicators, financial or accounting processes or standards
  — Methodologies used, including key assumptions and scenarios
  — Changes in absolute and relative amounts over time, such as acquisitions, divestitures or policy changes
  — Connection with business units, company strategy, and financial results
  — Criteria and indicators used to assess the level and impact of actual and potential climate change risks and opportunities
  — Impact to supply chains over time
  — Potential impact climate-related transition and physical risks might have on the organization’s inputs and outputs over time, including variables affecting availability, quality, or cost.

Metrics – Updates to guidance for all sectors

To support comparability across climate-related disclosures, the TCFD is proposing a discrete set of cross-industry, climate-related metrics that all financial and nonfinancial organizations should disclose (in addition to key industry- and company-specific climate-related metrics).

— GHG emissions (Scope 1 (direct emissions), Scope 2 (indirect emissions – owned), and material categories of Scope 3 (indirect emissions – not owned but linked to operations), including financed emissions). The absolute and intensity level of emissions is considered indicative of the organization’s exposure and vulnerability to changes in policies and technology aimed at transitioning to a low-carbon economy.

— Carbon prices (external and shadow/internal)

— Proportion of assets and/or operating, investing, or financing activities materially exposed to physical risk, based on key categories of commonly accepted risks (including acute risks (e.g., severity of extreme weather events) and chronic risks (e.g., variability of weather patterns, rising mean temperatures, rising sea levels)). These metrics may help to estimate potential financial exposure regarding impairment or stranding of assets and
liabilities, and changes in cost of business interruptions

- Proportion of assets and/or operating, investing, or financing activities materially exposed to transition risks based on key categories of commonly accepted risks (including policy and legal risks (e.g., increased pricing of GHG emissions, mandates on and regulation of existing products/services, litigation exposure), technology risks (e.g., substitutions with lower emission options, unsuccessful investments, costs to transition), market risks (e.g., cost of raw materials), and reputation risks (e.g., shifting consumer preferences, stigmas tied to products/services/inputs))

- Proportion of assets and/or operating, investing, or financial activities aligned toward climate-related opportunities, based on key categories of commonly accepted opportunities (including these types of opportunities: resource efficiency (e.g., more efficient transport, recycling, reduced water consumption), energy source (e.g., new technologies, shift to decentralized energy generation), products/services (e.g., low emission goods/services, climate adaptation and insurance risk solutions, diversified business activities, shifts in consumer preferences), markets (e.g., public-sector incentives, new assets and locations needing insurance coverage), resilience (e.g. participation in renewable energy programs, resource substitutes or diversification)). These metrics may provide insight into likely transition pathways and potential changes in revenues and profitability over time.

- Amount of senior management remuneration impacted by climate considerations (may provide a signal of governance, oversight, and accountability for managing climate-related issues)

- Amount of expenditure or capital investment deployed toward climate risks and opportunities (may provide indication of impacts to future earnings capacity).

Organizations should also disclose how climate-related metrics inform climate-related financial impacts, including financial performance (cost, profitability, operating cash flow, impairment) and financial position (assets and liabilities).

**Metrics – Updates to supplemental guidance for the financial sector**

In addition to changes to the guidance for all sectors, the TCFD is also proposing to update guidance specific to financial institutions (i.e., banks, insurance companies, asset managers, and asset owners). In particular, the TCFD proposes to:

- Expand disclosure of carbon-related asset metrics to insurance companies, asset managers and assets owners in addition to banks, as well as to expand the definition of “exposure to carbon-related assets” from the energy sector group to all non-financial sector groups.

- Develop guidance on options to measure the alignment of portfolio investments with climate goals. The TCFD’s second proposed document, Measuring Portfolio Alignment: Technical Supplement, sets out technical guidance on emerging best practice for building portfolio alignment tools and forward-looking metrics for financial portfolio alignment with the climate goals of the Paris Agreement (net-zero by 2050).

The TCFD recommends financial institutions:

- Measure and disclose the alignment of their portfolios with the goals of the Paris Agreement using forward-looking metrics
- Use whichever portfolio-alignment tool best suits their institutional “context and capabilities” but consider advancing along the spectrum of sophistication of approaches over time as tools improve in robustness, transparency, and ease of use (model tools are proposed along with evaluation criteria to help financial institutions design/select among the tools)
- Use portfolio-alignment tools alongside existing approaches to setting emissions reduction targets
- Use the tools alongside other purpose-built tools for quantifying transition risk.

**Climate-related targets**

- When selecting metrics, organizations should consider whether there is an associated target against which to track progress; targets typically have a numerical value. “Though not all metrics will require a target, all targets should be supported by appropriate metrics.” The TCFD proposes that climate-related targets should be:
  - Based on recognized metrics
  - Quantified and granular
— Designed in consideration of an organization’s strategy and forecasting, and informed by scenario analysis and climate science
— Clearly specified over time, including a baseline period against which progress is tracked, a time horizon for achieving the target, and interim targets
— Reviewed and updated when appropriate, though at least every five years
— Reported annually.

— Organizations should disclose key climate-related targets in their strategy and supporting operational and financial plans as well as annual progress against those targets. TCFD suggests it is particularly important for disclosures to incorporate GHG targets based on the target setting principles in order to assess the achievability and credibility of the organization’s net-zero ambition.

Climate-related transition plans
— An organization’s climate-related transition plan should provide a view of how the organization will minimize risks and capture opportunities as the organization and the business environment move toward a low-carbon economy (i.e., reducing emissions associated with its own balance sheet and that of its value chain).
— The TCFD suggests that an organization should disclose its transition plan if it has identified material transition risk, including if it: i) operates in a jurisdiction with an emissions reduction commitment, ii) has made an emissions reduction commitment, or iii) has to meet emissions reduction expectations from stakeholders, especially investors and lenders. TCFD adds that all other organizations should consider disclosing their transition plan if their business activity generates significant emissions (Scope 1, 2, or 3) or is materially dependent on carbon-related assets.

— As proposed, transition plans should be:
— Disclosed as part of the broader organization strategy
— Anchored in quantitative elements, including climate-related metrics and targets; designed in consideration of and in order to achieve targets; and regularly tracked against targets and metrics
— Approved by the Board, and regularly overseen by the Board and senior management with relevant climate expertise
— Actionable and linked to specific initiatives, with near-term accountability
— Detailed and verifiable by external stakeholders.

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