

SESSION NOTE

Enhancing Disclosure and Due diligence for Climate-related Risks

29 October 2019, 16:15-17:45

Introduction

1. There has been a significant increase in climate reporting across corporates and financial institutions since the introduction of the Paris Agreement in 2015. However, for climate disclosures to be useful to investors and their beneficiaries, significant improvements need to be achieved with respect to the coverage and quality of such disclosures. Inadequate and inconsistent information about climate risks and opportunities can lead to mispricing of assets and capital misallocation, which in turn can impact financial stability.
2. Improving climate reporting will involve responding to challenges related to availability and comparability of data and metrics, as well as methodologic issues associated with scenario analysis and carbon footprints. Additionally, better climate disclosure requires moving away from static, compliance-based reporting to due diligence reporting models which include disclosing how climate issues have been integrated in governance, strategy and risk management and what practical actions have and can be taken.

Date and metrics

3. The Montreal Pledge, the Portfolio Decarbonization Coalition, the Science Based Targets initiative and the Task Force on Climate-related Financial Disclosures (TCFD) all encourage institutional investors to gather data and develop metrics and targets to assess climate risks and opportunities. A mix of various indicators is needed to guide investors' strategy, decision-making and disclosure.
4. However issues related to scope, availability and comparability of data and metrics continue to represent challenges to strong climate disclosure. For example, the most commonly used metrics by financial institutions – carbon footprint¹ or

¹ A portfolio's carbon footprint is the sum of a proportional amount of each portfolio company's emissions (proportional to the amount of stock held in the portfolio). PRI (2015), "How measuring a portfolio carbon footprint can help." <https://www.unpri.org/climate-change/how-measuring-a-portfolio-carbon-footprint-can-assist-in-climate-risk-mitigation-and-reducing-emissions/608.article>

weighted average carbon intensity² – are generally limited to Scope 1 and 2 emissions. This can represent a significant gap as Scope 3 emissions often represent the majority of an entity’s GHG emissions – in some cases up to 90%.³ Additionally, a lack of comparability across climate disclosures of financial institutions continues to undermine their utility. An EY analysis of reports filed in response to Article 173-VI of the French Energy Transition Act found that while “investors disclosed metrics linking investees’ GHG emissions to key financial indicators and assessing alignment of these emissions with a 2°C scenario ...[m]ethodological limitations make any comparison of these metrics impossible”⁴

5. A lack of quality data at a corporate level has been raised as a central challenge by institutional investors in both pursuing responsible investment strategies and in turn providing quality disclosures themselves. For example, 68% of asset owners surveyed in a Morgan Stanley study noted that a lack of availability of quality ESG data is the leading challenge to responsible investment.⁵

6. Moving forward, enhancing Scope 3 reporting and climate disclosures at a corporate level can provide financial institutions with the information they need to enhance their own climate reporting. Additionally, convergence of various frameworks and standards with respect to climate reporting can be useful to ensure comparability and avoiding a proliferation of approaches.

7. As part of its implementation of the Sustainable Finance Action Plan, the EU is currently developing a taxonomy to reflect commonly agreed principles and metrics for assessing environmentally sustainable activities for investment purposes and has introduced a regulation on low-carbon benchmarks.

Scenario analysis

8. Defined as a “process for identifying and assessing a potential range of outcomes of future events under conditions of uncertainty”⁶, scenario analysis can help investors assess how climate-related physical and transition risks may impact their strategies, investment decisions and financial performance over time. Ideally, scenario analysis should be forward-looking, consider a diversity of scenarios (e.g. a

² Weighted Average Carbon Intensity measures a portfolio's exposure to carbon intensive companies. Since companies with higher carbon intensity are likely to face more exposure to carbon related market and regulatory risks, this metric can serve as a proxy for a portfolio's exposure to potential climate change-related risks relative to other portfolios or relative to a benchmark. MSCI (2015), “Carbon Footprinting 101” <https://www.msci.com/documents/10199/2043ba37-c8e1-4773-8672-fae43e9e3fd0>

³ The Carbon Trust (2013) Make business sense of Scope 3 <https://www.carbontrust.com/news/2013/04/make-business-sense-of-scope-3-carbon-emissions/>

⁴ EY (2017b), How have investors met their ESG and climate reporting requirements under Article 173-VI?, [www.ey.com/Publication/vwLUAssets/ey-how-have-investors-met-their-esg-and-climate-reporting-requirements-under-article-173-vi/\\$FILE/ey-how-have-investors-met-their-esg-and-climate-reporting-requirements-under-article-173-vi.pdf](http://www.ey.com/Publication/vwLUAssets/ey-how-have-investors-met-their-esg-and-climate-reporting-requirements-under-article-173-vi/$FILE/ey-how-have-investors-met-their-esg-and-climate-reporting-requirements-under-article-173-vi.pdf).

⁵ Morgan Stanley (2018), Sustainable Signals, www.morganstanley.com/assets/pdfs/sustainable-signals-asset-owners-2018-survey.pdf.

⁶ TCFD (2017), Recommendations of the Task Force on Climate-related Financial Disclosures <https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf>

2°C or 3°C scenario) and assumptions, and be geography specific.⁷ Dynamic climate-risk stress testing is a tool similar to scenario analysis.

9. However, there are significant methodological and data challenges to integrating scenario analysis in investors' strategies and across different asset classes. In this respect, most data at a corporate level focuses on key performance and financial indicators. More granular data and metrics relevant for understanding exposure to climate risks overtime (e.g. installed capacity of a power project; or length of roads) continues to be lacking. Furthermore, gathering such data can involve significant costs and resources internally, which can create challenges for small asset managers. More broadly, a lack of consensus on the very definition of a 2°-aligned portfolio and methodological issues linked to allocating macro-level impacts to micro-level actors, sectors, countries, asset classes and portfolios also present challenges.⁸

10. Scenarios analysis has consistently been identified as one of the most challenging areas for climate risk management as well as disclosure. The 2019 progress report of the TCFD found that even among companies using scenarios, the majority do not disclose information on the resilience of their strategies.⁹

11. In response to these challenges, governments and other organisations have been active in developing tools for investors and other sectors to facilitate scenarios analysis development and reporting.¹⁰ Continued co-operation amongst regulators, international organisations, civil society and institutional investor is needed to help refine scenario analysis. Further capacity building at the level of corporates as well as financial actors will also be important to overcoming current barriers.

Due diligence reporting

12. Reporting on climate due diligence can demonstrate the level of ambition and robustness of a company's or investor's approach to managing climate risks. It can also demonstrate the relative significance attributed to climate-related risks in relation to other risks such as labour, human rights and development impacts, as well as intersections between these types of risks. The OECD recommends that due diligence reporting include information about a company's policies on climate and other ESG issues, information on measures taken to embed those policies into management systems, identified areas of significant risks, as well as specific priority risks areas, and the actions taken to prevent or mitigate those risks.¹¹

⁷ Id.

⁸ CICERO (2018), "Climate Scenario demystified – A climate scenario guide for investors" <https://cicero.oslo.no/en/posts/news/scientists-demystify-climate-scenarios-for-investors> and Mercer (2015), "Investing in a time of climate change" <https://www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html>

⁹ Three out of five companies responding to the TCFD survey that view climate-related risk as material and use scenario analysis to assess the resilience of their strategies do not disclose information on the resilience of their strategies. TCFD (2019) 2019 Status Report <https://www.fsb-tcf.org/publications/tcf-2019-status-report/>

¹⁰ See broadly TCFD Hub Scenario Analysis <https://www.tcfhub.org/scenario-analysis/>

¹¹ See OECD (2018) Due Diligence Guidance for Responsible Business Conduct <https://mneguidelines.oecd.org/OECD-Due-Diligence-Guidance-for-Responsible-Business-Conduct.pdf>

13. Due diligence reporting is increasingly being integrated into frameworks for climate disclosures.

14. For example, the TCFD Recommendations call for reporting on climate metrics and targets as well as:

- Governance around climate-related risks and opportunities;
- Strategy, including actual and potential impacts of climate-related risks, and opportunities in the organization’s businesses, strategy and financial planning
- Risk management, or how an organization identifies, assesses and manages climate-related risks

15. The EU Regulation for Sustainability-related Disclosures in the Financial Services Sector, approved earlier this year, introduces transparency rules for financial institutions, including expectations on due diligence reporting. This year the European Commission also introduced non-binding guidelines on climate reporting under the EU Non-Financial Reporting Directive (NFRD), which require large firms to report on environmental and social information, including their due diligence processes.

16. Due diligence reporting is also partially intended to promote mainstreaming of ESG, including climate risks, into broader decision making and risk management processes. A finding of the 2019 progress report of the TCFD however was that such reporting was overwhelmingly assigned to staff with corporate or sustainability functions and additional mainstreaming of climate risks across functions of risk management, finance, and executive management was needed.¹² Similarly, a stocktaking of reports filed under the Article 173 of the French Energy Transition Act concluded that climate reporting is often outsourced to external service providers and thus has not been used in driving changes to management practices.¹³ As such, more effort needed to ensure due diligence reporting drives mainstreaming of climate risk management into broader governance and risk management processes.

Conclusion

17. Climate disclosures at a corporate and investor level are increasingly common. However better, rather than more climate disclosure is required to ensure climate disclosures play a meaningful role in driving climate action. In this respect further improvements in data and metrics, scenario analysis, understanding of interlinkages between climate risks and other risks areas, and mainstreaming of these issues into governance and risk management processes will be necessary.

¹² Idem, note 9

¹³See I4CE (2018), “Article 173: Overview of climate-related financial disclosure after two years of implementation” <https://www.i4ce.org/wp-core/wp-content/uploads/2018/11/1210-I4CE2949-PC59-Article173-nov18-VA.pdf>