Investors Push the Pace of Climate Risk Financial Disclosures

The Yale Center for Business and the Environment

ERM

May 2018

Yale Center for Business and the Environment

ERM The business of sustainability

EXECUTIVE TAKEAWAYS

A survey of almost 100 investors reveals a significant and accelerating commitment to better understand climate change risks in the financial disclosures of companies. This commitment has taken shape through support for the Task Force on Climate-related Financial Disclosures (TCFD). We asked investors about expectations arising from the TCFD and found:

- Investors have become a significant voice in the call for climate change risk disclosure.
- The timeline for investor expectations on climate change risk disclosure are shorter than many companies might expect.
- There is a strong appetite amongst investors for disclosure in mainstream financial reports.
- There is extensive movement by regulators and standards organizations around the world to meet this investor demand.

INTRODUCTION

The Rise of ESG Investing

Investors have been tracking a rising tide of data that relates broad environmental and social concerns with the financial performance of companies. A recent boom in empirical studies has also correlated environmental, social and governance (ESG) aspects to stronger management techniques, better financial performance and stock price benefits in the short, medium and long terms.[1] The reasons for these correlations are less clear, however, and they vary by sector, region and even individual company. The result is that investors can be reasonably sure that consideration of ESG factors is important for a smart investment strategy, but the specific ESG factors that should be tracked are unknown.[2]

A number of investment strategies have arisen in this context. On one side of the ESG investment spectrum are *values* investors that seek to create social and environmental benefit through their investments, even if this means slight under-performance of financial returns. These investors include impact investors, so-called socially responsible investors (SRI) and investors that screen companies based on sector or activity (for example tobacco, gambling, alcohol or fossil fuels). On the other side of the spectrum are *value* investors that see these ESG factors as important corporate performance measures that can be used to identify and exploit market opportunities as well as mitigate and manage material risks. For these investors, ESG investing is a strategy to maximize financial returns.

Common across these ESG investment strategies is the notion that some issues are so pervasive—most notably climate change—that the well-being of people, the environment, companies and economic growth are inextricably linked. Climate change has thus emerged as the "tip of the spear" in ESG investment strategy because the risks to companies from inaction are increasingly intuitive and the opportunities to position a company in the emerging low-carbon economy are increasingly enticing. But identifying the potential corporate losers and winners in a low carbon world is challenging. Disclosure is inconsistent, data is methodologically challenged and risks from climate change are unclear when applied to large and complex company operations. The result, from the perspective of investors, is a hodge-podge of information that makes strategic investment decisions based on climate risks and opportunities extremely challenging.

The Task Force on Climate-related Financial Disclosure

In an effort to guide companies in the disclosure of information that's more useful for investors, lenders and insurers as they make decisions on risks and opportunities arising from climate change, the Financial Stability Board (FSB) launched the Task Force on Climate-related Financial Disclosure (TCFD) at the end of 2015. Supported by leading financial institutions around the world, the TCFD issued three publications in 2017:[3]

- Recommendations of the Task Force on Climate-related Financial Disclosure
- Annex: Implementing the Recommendations of the TCFD
- Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities

Together, these documents provide companies with voluntary guidance on identifying and disclosing climate change-related risks and opportunities. The guidance is intended to provide a consistent format of risk assessment to support not only disclosure to investors, but also to allow consistent management of these risks and opportunities for the company itself.

The TCFD recommendations have several important elements. First, the TCFD has recommended that risks and opportunities be assessed using a two-degree scenario (a scenario in which climate change is held to within 2 degrees average temperature rise from pre-industrial levels). This is intended to provide a consistent scope and boundary of identified risks. Significantly, it leaves investors to assess the likelihood that the world will act to limit carbon emissions consistent with a two-degree scenario. So while the guidelines can provide useful information to investors that see climate change as a material risk, they do not demand companies take a position on the whether these risks are likely to occur.

The TCFD also provides a consistent, and for many companies expanded view on the types of risks and opportunities that should be considered. Specifically, the TCFD identifies risks and opportunities related to both mitigation (impacts from the need to curb carbon emissions) and adaptation (impacts from the consequences of climate change such as severe weather).

Finally, the TCFD recommendations specifically guide disclosure of these risks into financial reporting as opposed to separate sustainability reports, which target a broader audience of stakeholders. This has potentially significant implications for the level of data control and the criteria by which risks are assessed and measured.

The Current Disclosure Gap

The CDP and Climate Disclosure Standards Board (CDSB) recently assessed the gap between current disclosure on climate change risks and the expectations delineated by the TCFD recommendations. The findings highlight an important disconnect: while most companies identify severe weather or climate policy developments as risks in their financial reporting, there is a significant lack of scenario-based assessment, broader risk assessment or information on governance for climate change risks.[4]

A detailed study of Canadian companies in 2017 supports these conclusions, finding that "few companies provide a meaningful analysis demonstrating the actual and expected impacts of climate-related developments on financial results and the company's business, operations and strategy." The study also found that less than 10% of companies reported greenhouse gas emissions data in their financial reports and another 10% directed investors to external, reports.[5]

The gap concerns more than simply disclosure. In 2018 ERM surveyed 120 Chief Financial Officers and Chief Sustainability Officers and found that, despite increasing investor pressure, the finance function is lagging in its awareness and prioritization of climate risks. The result is a lack of tools to accurately shape and report on these risks and opportunities.[6]

Companies face an uphill battle to respond to investor expectations, and, more fundamentally, to better understand which climate risks are material and to develop strategies that will meaningfully mitigate these risks while positioning the company for growth.

Investor Survey Methodology

In light of this reality, it is important for companies to understand:

- The degree of urgency, and;
- The pace of change to disclose information in line with the TCFD.

The Yale Center for Business and the Environment (CBEY) in partnership with ERM, the world's leading sustainability consultancy, undertook a survey of asset managers, asset owners, insurers and lenders (collectively referred to as "investors") in an attempt to understand both of these variables. The survey request was sent out to individuals representing over 200 investor companies with combined assets under management (AUM) of over 20 trillion dollars. Ninety-nine (99) responses (approximately 48%) were collected both on-line and through telephone interviews over the course of 6 weeks from January to February 2018. Survey responses were unattributed to promote the response rate.

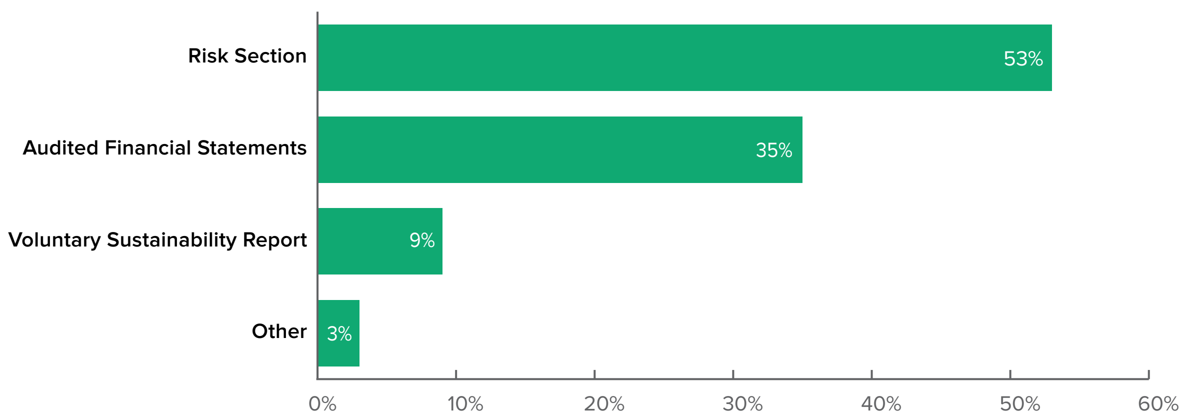
Our objective was to better understand perceptions of investors toward the TCFD and the extent and pace of investor expectations for disclosure of climate risk in financial reporting. We present these findings below along with our assessment of the challenges that these expectations present.

TRENDS IN INVESTOR INTERESTS

Moving from Voluntary Reporting to Mainstream Financial Disclosure

The first significant finding of the survey is that investors are increasingly looking to mainstream financial reports for climate risk information. Almost 90% of respondents indicated that climate risk information belongs either in the risk section (53%) or the audited financial statements (35%) of these reports.

If Your Company is Seeking Greater Disclosure, What Format are You Seeking?



It is worth considering two key implications of this investor expectation:

1—PROCESSES UNDERTAKEN BY COMPANIES TO ASSESS ENVIRONMENTAL AND SOCIAL RISKS.

Research by the World Business Council for Sustainable Development (WBCSD) has indicated that there is a significant gap in the risks disclosed between sustainability reports and financial reports.[7] This gap suggests that the processes, tools and criteria employed by companies to identify risks and opportunities differ when we are talking about *financial* risks and *sustainability* risks. Indeed, sustainability practitioners and financial reporters apply the very concept of materiality differently.[8]

As a result, there has been a flurry of activity to better reconcile risk assessment and materiality processes for ESG information. Of particular note is the recent effort by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the WBCSD to provide guidance on enterprise risk management processes for integration of ESG risks.[9] The preliminary guidance suggests criteria, governance structures, tools and responses to broad sustainability risks facing a company. Parallel efforts by the International Accounting Standards Board, International Integrated Reporting Council and others are also looking at processes and methods for aligning materiality of ESG factors with financial disclosure standards.[10] Common among these efforts is the idea that ESG factors must be assessed with an eye toward broader understanding of risks while also adhering to standards of data quality and methodological rigor.

These efforts are not occurring in isolation. Investor expectations for disclosure of climate-related risks—and sustainability risks more broadly—have grown alongside new financial disclosure regulations. The US Securities and Exchange Commission (SEC) released guidance on climate change disclosure in 2010[11] and recently followed up to solicit feedback on this guidance.[12] Countries around the world have issued regulations requiring greater disclosure of material environmental and social risks in financial reporting.[13] As these regulations evolve, they will rely on emerging practices in risk assessment and materiality to better guide company disclosure.

2—THE NATURE OF THE DATA

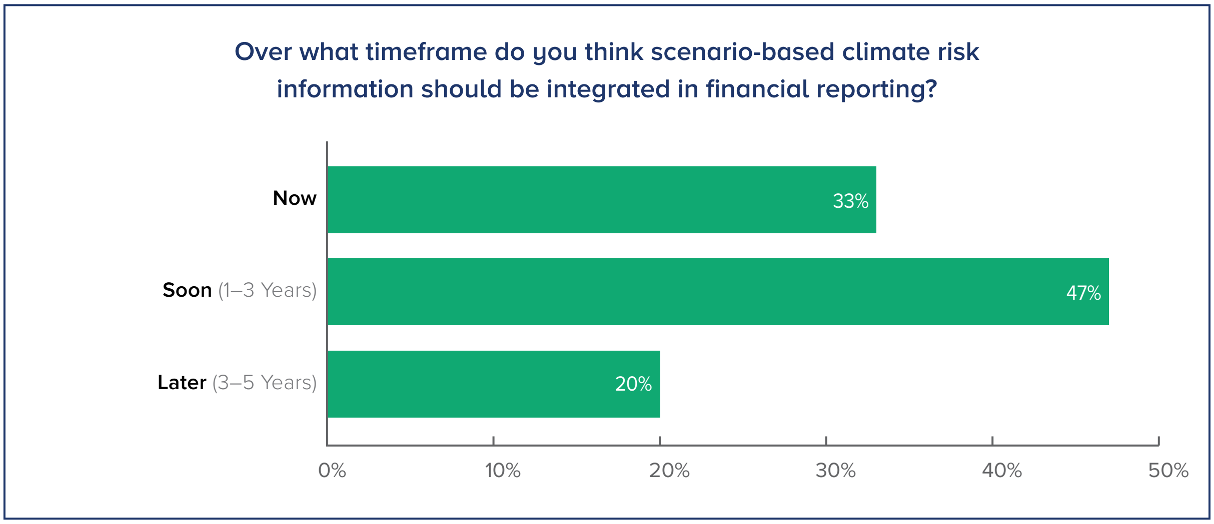
Particularly if climate risk information moves into audited financial statements, we would expect to see substantial changes to data quality standards. This shift would entail new methodological standards for collection and disclosure of climate-related risk data as well as associated interpretations of accounting standards to allow auditors to sign off on the validity of the data. We can also expect to see some level of consolidation around a core set of metrics that are widely applicable within sectors in the mold of the Sustainability Accounting Standards Board (SASB) industry standards.[14]

Overcoming these data challenges will be a significant undertaking. Esty and Cort have outlined a wide range of methodological and application challenges associated with ESG data and advocated for methodological standards, a tiered set of metrics and an appropriate level of regulation to drive comparability.[15] Such an evolution in data quality will likely take time; it appears, though, that investors do not have patience when it comes to climate-related disclosure.

An Accelerating Timeframe for Disclosure

In order to assess the pace of change, we surveyed investors on how soon they expect climate-related risk information to move into financial reports. The results were again noteworthy. A third of respondents expect information in the 2018 financial year disclosures and 47% expect information within three years.

While this timeframe presents challenges for companies, it is not surprising. Support for the TCFD, particularly amongst investors, appears to be accelerating. The UN Principles for Responsible Investing (UNPRI) has recently announced its support for the TCFD. This includes solicitations to governments around the world to formally require TCFD-compliant disclosure, and an initiative to guide investors that wish to adopt the TCFD for their own portfolio analysis. Blackrock, the large asset management company, is also throwing its support behind the TCFD recommendations; and a letter in February 2018 from CEO Larry Fink promised a renewed commitment by the company to be a more active advocate for environmental and social impact disclosure from its managed assets.[16]



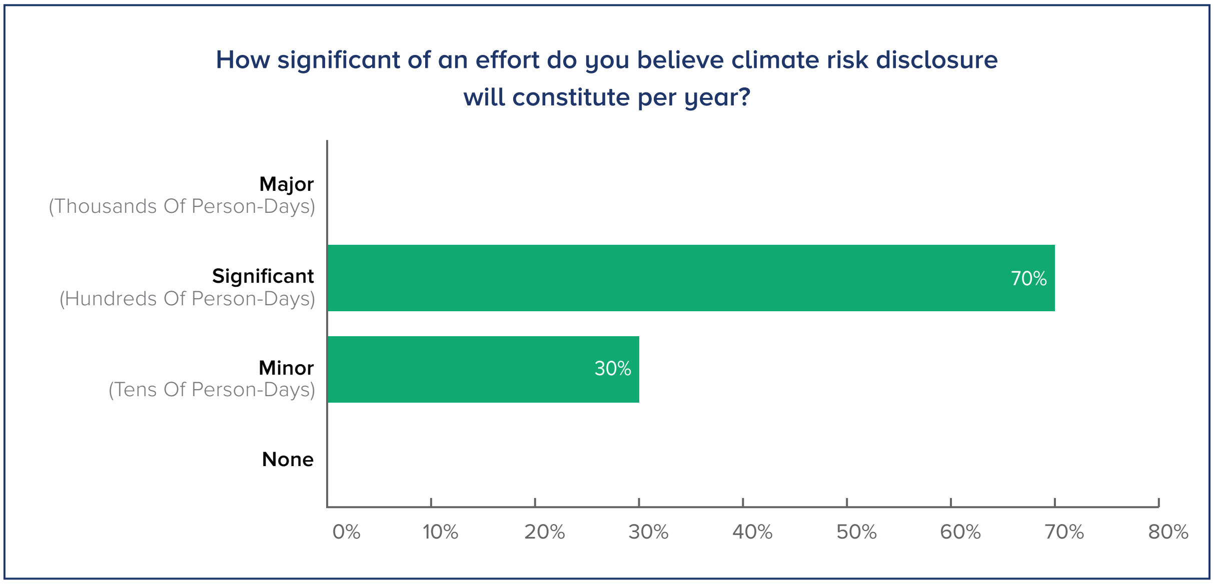
This investor pressure is also influencing regulators. On January 31 of this year, the EU High Level Expert Group (HLEG) on Sustainable Finance released "Financing a Sustainable European Economy."[17] In this report, they explicitly endorsed the TCFD recommendations and pointed to the upcoming review of the EU Non-Financial Reporting Directive (in 2018/2019) as the opportunity for the EU to formally implement the TCFD recommendations as reporting requirements. This would likely include forward-looking disclosures.

The pace of change and the expectations of participants make the competing priorities clear. Investors are keen to understand risks in the near term and regulators, particularly in the EU, would like to move efforts to protect from climate change and other environmental and social impacts. However, most are wary of radical shifts in the economic system and are proponents of steady, yet rapid, progress. HLEG, for example has proposed a staged approach to adoption that allows reflection while pushing for progress before 2020.

Level of Effort

Given the high expectations and accelerating timeframe, it is natural to ask how much time companies should expect to commit in the short-term if they choose to adhere to the TCFD recommendations. We asked our investor group this question. Our intent was not to arrive at a firm number, but rather to gather one perspective. The result suggests that investors see this as a significant, but not over-burdensome, undertaking. Most respondents responded in the hundreds of person-days (or 1 to 3 full time equivalents).

While the level of effort will be unique to each organization, it is clear that time commitments will come from many different people throughout the company. ERM, which was a key contributor to the Technical Supplement on scenario analysis for the TCFD, noted many of the key employees for adopting the recommendations.[18] First is leadership, including the CEO and Board; they will need to understand climate risks on long-term strategic planning and future financial growth. Second is investor relations, which will need to work closely with sustainability professionals to understand the risks and communicate them in an



appropriate manner to investors outside the financial report. The CFO, accounting teams, enterprise risk management teams and internal auditors will also need to participate as information is moved into the financial report.

Although many companies may devote dedicated resources to adopting the TCFD, it is probably a mistake to conceive of TCFD as an 'extra add-on' to the business and disclosures. Rather, given the integrated nature of climate risk, it is more appropriate to conceive of the time commitment across many different people in many different functions working together to establish a best path forward.

BRIDGING THE GAP

Companies are looking to move forward given investor expectations with regard to the TCFD. A variety of efforts underway should serve as resources.[19] In fact, the number of resources can be overwhelming. Fortunately, it is possible to point to some common elements across resources that companies will likely need to address when adopting the TCFD recommendations.

Data Systems

Not only will expectations for data quality and validation increase, but companies will likely see new interest in the type of data collected. While greenhouse gas emissions inventories will play a major role for investors, this is only a partial insight into mitigation risk. Companies may also see requests for data regarding resilience to climate change impacts such as severe weather and water scarcity. The same is true of data that is used to construct scenarios, used to assess risks discussed in the financial report or placed directly into the financial report. For many companies, this means investments in data collection, aggregation and auditing activities. It is also possible, that companies may see a re-emergence of *reasonable* levels of assurance for key climate change risk data (as opposed to limited assurance, which predominates today).

Scenario Analysis

The TCFD recommendations are founded on scenario analysis as the preferred method to generate comparability between companies on material risks from climate change. This entails companies creating or accessing two-degree scenarios in order to identify which aspects will impact them.

Robust scenario analyses have several common features. They include plausible views on markets (supply and demand), regulations, policies and physical risks to both operations and logistics chains. They also provide insight on technology trends. The TCFD, with research and technical support from ERM, has published a Technical Supplement on scenario analysis that incudes a host of resources and guidance frameworks.[20].

Materiality

Materiality of climate risks will need to be better understood moving forward. Specifically, the process for assessing *what is material* will need to be aligned with the standards used to compile the financial disclosures. In this case, process refers to the criteria, procedures and stakeholders incorporated to assess whether a risk is material to the interests of investors. This will require companies to understand what is *decision-useful information* for investors while also ensuring that the information meets the accounting standards and thresholds for reporting in the annual financial reports and/or audited financial statements.

While this field is in early stages, there are thought pieces and top-level guidance available to both financial and sustainability teams.[21] For the most part, these documents point toward a multi-part system of materiality. The first part is a broad application of materiality based on the priorities of a wide range of stakeholders. The second part looks at a small list of core indicators and associated metrics that are widely applicable across most companies within a sector. The third part looks at indicators that are fully integrated between sustainability assessments and financial assessments either as an integrated report or as supplemental information within the annual financial disclosures.

Strategic Response

The sum of these efforts—data, scenario analysis and materiality—should provide new levels of insight on risks from climate change and other sustainability issues. Not only should this improve communication and disclosure for investors, but it should give businesses more valuable assessment of risks and opportunities. Through deeper insight into the magnitude and probability of trends in markets, capital investments, regulations, supply chain logistics, etc, companies should be better positioned to grow investment returns. This insight should also improve management responses to identified risk through strategic planning, hedging, risk deferment or control mechanisms.

ENDNOTES

1 Friede, G., Busch, T., & Bassen, A. (2015). ESG and financial performance: aggregated evidence from more than 2000 empirical studies. *Journal of Sustainable Finance & Investment*, *5*(4), 210-233.

2 Esty, D. and Cort, T. (2017) Corporate sustainability metrics: what investors need but don't get, *Journal of Environmental Investing*, (8) 1.

3 https://www.fsb-tcfd.org/publications/

4 CDP and CDSB (2018) Ready or not: Are companies prepared for the TCFD recommendations? A geographical analysis of CDP 2017 responses.

5 CPA Canada (2017) State of Play: Study of climate-related disclosures by Canadian Public Companies.

6 ERM (2018) Climate change risk: the new investment fundamental

7 WBCSD (2017) Reporting matters: Striking a balance between disclosure and engagement.

8 CDSB (2017) Position paper: Materiality and climate-related financial disclosures.

9 COSO and WBCSD (2018) Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks [Preliminary Draft].

10 International Accounting Standards Board (2017) Definition of Material; International Integrated Reporting Council (2015) Materiality in <IR> - Guidance for the preparation of integrated reports

11 Securities and Exchange Commission (2010) Commission Guidance Regarding Disclosure Related to Climate Change

12 Securities and Exchange Commission (2016) Concept Release on Business and Financial Disclosure required by Regulation S-K.

13 see for example the UK Companies Act (2006) and the European Union Directive on disclosure of non-financial and diversity information by certain large companies; 2014/95/EU

14 See the SASB industry standards at https://www.sasb.org/download-the-standards/

15 Esty, D. and Cort, T. (2017) Corporate sustainability metrics: what investors need but don't get, *Journal of Environmental Investing*, (8) 1.

16 https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter

17 https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

18 ERM (2018) Climate change risk: the new investment fundamental

19 See for example:

a. TCFD (2017) Annex: Implementing the Recommendations of the TCFD

b. CDSB (2017) Position paper: Materiality and climate-related financial disclosures.

c. WBCSD (2017) CEO Guide to Climate-related Financial Disclosures

d. CDSB (2017) Uncharted waters: How can companies use financial accounting standards to deliver on the Task force on Climate-related Financial Disclosures' recommendations?

e. WBCSD (2018) Insights from the Reporting Exchange: ESG reporting trends

f. EU High Level Expert Group on Sustainable Finance (2018) Financing a Sustainable European Economy, Final Report 2018

g. UN PRI (2018) TCFD Recommendations: Country Reviews; https://www.unpri.org/policy-and-regulation/tcfd-recommendations-country-reviews/278.article

h. UN PRI (2018) Voluntary Climate Reporting Indicators based on the TCFD Recommendations

i. UNEP FI (2018) Webinar series on a pilot project for implementation of the TCFD; http://www.unepfi.org/banking/tcfd/

j. Institute of International Finance (2018) Forum on implementation of the TCFD recommendations; https://www.iif.com/press/iif-launches-forum-implementation-tcfd-recommendations

20 TCFD (2017) Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities; https://www.fsb-tcfd.org/wp-content/uploads/2016/11/TCFD-Technical-Supplement-A4-14-Dec-2016.pdf

21 See for example:

a. CDSB (2017) Position paper: Materiality and climate-related financial disclosures.

b. COSO and WBCSD (2018) Enterprise Risk Management: Applying enterprise risk management to environmental, social and governance-related risks [Preliminary Draft].

c. International Accounting Standards Board (2017) Definition of Material

d. International Integrated Reporting Council (2015) Materiality in <IR> - Guidance for the preparation of integrated reports

e. Esty, D. and Cort, T. (2017) Corporate sustainability metrics: what investors need but don't get, *Journal of Environmental Investing*, (8) 1.

f. SASB Materiality; https://www.sasb.org/materiality/important/

FOR MORE INFORMATION ON THIS PAPER CONTACT:

Todd Cort
Lecturer in Sustainability at Yale School of Management
Faculty Co-Director at Yale Center for Business and the Environment
todd.cort@yale.edu

James Stacey
Partner, ERM
james.stacey@erm.com

ABOUT THE YALE CENTER FOR BUSINESS AND THE ENVIRONMENT (CBEY)

The Yale Center for Business and the Environment generates, incubates and launches business solutions to pressing environmental problems by 1) bringing theory to practice through innovative applied research projects and engaged learning across our global networks and 2) educating and training multi-disciplinary, global sustainability leaders. The Center joins the strengths of two world-renowned graduate schools—the Yale School of Management and the Yale School of Forestry & Environmental Studies—together with an extensive network of internal and external thought leaders at the nexus of business and the environment.

cbey.yale.edu

ABOUT ENVIRONMENTAL RESOURCES MANAGEMENT (ERM)

Is a leading global provider of environmental, health, safety, risk, and social consulting and sustainability related services. We have more than 4,500 people in over 40 countries and territories working out of more than 160 offices. ERM is committed to delivering solutions while providing a service that is consistent, professional and of the highest quality to create value for our clients. We have worked with many of the Global Fortune 500 companies delivering innovative solutions for business, providing bankable advice that has underpinned billions of dollars of investment decisions. For all we have helped them understand and manage the sustainability challenges that the world is increasingly facing.

www.ERM.com