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Brief

The British Approach to the World's Best Framework for Climate-Related and Sustainability-Related Financial Disclosure

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Abstract

FEEM Policy Brief

Sustainability, and more specifically climate change, are finally playing a larger role in policy-making processes, as their implications and repercussions have an impact that can no longer be ignored. The Paris Agreement at COP21 has played its part, inducing governments to clarify their national commitments (NDCs) towards reducing carbon emissions and making polluters more accountable for their actions. COP21 led not only to government commitments, but also to a rapid increase in public (and thus investor) awareness on this topic. And with awareness comes information, or better, demand for more information, more data. In the aftermath of the financial crisis, investors have become eagerly averse to systemic risks, and are requesting firms to disclose their efforts to tackle climate change in terms of risk mitigation and seizing opportunities.

01 Introduction

This is the background to the formation of the Taskforce on Climate-Related Risk Financial Disclosure (TCFD), a group of Chief Executive Officers from leading companies across the globe who, captained by Michael Bloomberg and Mark Carney from the Bank of England, yielded a list of recommendations useful for the disclosure of the risks and opportunities linked to climate change and their impact on the financial performance in the medium/long term (TCFD, 2017). The aims of having a more disclosed and transparent system when looking at these risks are twofold: improving capital allocation from investors and stimulating greener investments in international markets.

Within this young, yet wide context, London has placed itself at the heart of the development of green finance, and it is not a coincidence that its financial hub led to the formation of the TCFD and the system that is beginning to evolve around it. Indeed, the United Kingdom has the intention to acquire and maintain a leadership role in this widening branch of finance, and to accomplish such intention it has established a Green Finance Taskforce (GFT) that is supported directly by its Government, and a Green Finance Initiative (GFI) which was instead launched by the City of London Corporation. These public and private-led working groups joined forces to draft a framework that could integrate the TCFD recommendations into the current UK corporate governance and reporting structure in an effective and timely manner and that could provide further guidance consistent with the ongoing Sustainable Development Goals (SDGs).

The solutions that the joint groups came up with are listed in a report published in March 2018 (UK GFT, 2018), that (as the title clearly points out) are not just a mere description of how to integrate recommendations into the British system, but rather a framework that can be expected to work globally once implemented - an ambitious, yet compelling - objective. The report follows this structure: the beginning sets out the reasons behind the need to integrate a set of recommendations into existing regulations; a second section denotes the aims of this report; a final section points out how to achieve the goals set out in the second section – namely, the recommendations. This brief will outline the highlights of the report, in order to make clear the main concepts of this suggested framework.

02 Expressing the case for transparency and disclosure

The report begins by confirming that there are strong arguments in favour of neater and more transparent disclosure of climate-related risks and opportunities. These arguments fall within three main categories: economic outcomes, more trust in capital markets and financial stability. The report further outlines that the three are in relation with each other, forming a virtuous circle around which the arguments stimulate each other. This brief will briefly outline how each argument favours the integration of disclosure recommendations, indicated by category.

The first economic outcome discussed concerns the Paris Agreement and the Sustainable Development Goals: indeed, a more transparent disclosure of how the strategy of a company accounts for and reacts to climate-related risks allows investors to consider whether the company is in fact aligned with International commitments such as the Paris Agreement and the SDGs. The report considers this aspect as a stepping stone towards a positive contribution to environmental policies' objectives. The second economic outcome concerns the role that London would play in this green financial scenario: as the authors concur that information is at the core of financial activity, London should indeed focus on gathering the most reliable information systems on sustainability-related risks, so as to maintain its competitive advantage over other hubs. This could be the key step towards a global leadership in this field. The third economic outcome discussed by the report regards the benefits that the UK would gather from an increase in productivity and growth: evidence shows that firms implementing sustainability practices do indeed show a lower cost of capital, a higher productivity and a better stock market performance (Clark, 2015)

The second argument mentioned is trust in capital markets. Indeed, as mentioned earlier in the brief, disclosure and transparency should lead to more trust in capital markets and favour a more efficient capital allocation. Looking specifically at the case for London, increasing or strengthening its international reputation at this specific moment can be considered highly beneficial – considering the uncertainty derived from Brexit. Legal litigations may also be less of a threat for companies and directors if disclosure frameworks help the latter to better assess and manage environmental risks.

The final argument expressed by the report is financial stability. The Bank of England, just like other central banks, has argued that climate change mitigation policies can help it meet monetary and financial stability objectives. The risks that could generally affect central banks (just like any other firm) are the two highlighted by the TCFD, namely transition and physical risks. Misleading or even thoughtless mitigation policies may drastically affect the value of assets that central banks and other asset owners have in their balance sheets, leading to a halt, rather than an enhancement, of the transition towards a low-carbon future.

The access to valuable information by financial institutions stands before effective policies: the provision of comprehensive disclosures will benefit investors for their investment decisions, but also regulators who are planning to fix gaps in the system. Ensuring good information via greater transparency will thus improve financial stability.

03 Intermediate Steps

The second and third sections are devoted to the objectives that the authors of the report (thus the GFI and the GFT) are seeking to achieve and how they are planning to achieve them. Their main concern is the integration of the TCFD recommendations within the existing UK regulations (the corporate governance and reporting frameworks): they suggest that the incorporation ought to occur with ease (or with no further regulations) if thoroughly supported by financial regulators. They also recognise the necessity of revising the regulations to smooth the integration process, derived from and backed by a set of guidelines that have the purpose of making the recommendations simpler to implement and that will require revisions every two years.

What can definitely be considered as a novelty of this report are the Sustainability-related Financial Disclosure (SFD) Recommendations, a set of voluntary parameters that a company can release in order to improve the quality of information provided to investors. According to the GFI and the GFT, these additional recommendations would include elements not generally comprised by the TCFD's proposals, such as the disclosure of green revenues by product and/or service to see how companies' business models are changing over time, or the publication of adaptation plans to disclose their intention to manage physical risks, or even recommendations for banks to tag and "back-tag" outstanding and future loans with information regarding sustainability-related risk, opportunity and impact. Asset-level data disclosure is also included in the menu, by which preparers are called to disclose essential information on those physical assets that are expected to bring revenues and how a transition phase could affect their value in time (impairments). Such data ought not to be commercially sensitive, rather, it should help investors understand the company's steps in their transition and adaptation processes – by looking at coordinates of facilities, the age of facilities and what type of technology is employed over at those facilities.

Although the integration of the TCFD and the SFD's recommendations is at the core of the scope of the report, the authors did not disregard solutions to support the adoption and implementation of the presented recommendations. They begin with possibly the most straightforward of the suggestions that can be given to corporate governance: knowledge and training. Introducing these proposals within corporate governance requires key decision-makers to fully understand the fundamentals and the implications involved with such proposals. Although the guidelines evoked by the authors do not prescribe explicit training for senior managers and directors, the Board of Directors should ensure that they have in fact sufficient competences by including non-executive experts in their boards. The degree of climate-related skills that must be learnt from these experts will vary depending on the urgency.

Another suggestion that the authors have made to strengthen the case for disclosure is for the British Government and regulators to install and publish a list of annual benchmarks or rankings that trace the degree of disclosure of every company that is required to follow the disclosure frameworks, with the double purpose of encouraging companies to increase their transparency and providing investors with a tool for comparison that can facilitate investment decisions (as clear distinctions can be made between those firms ahead and those lagging behind). The report duly points out that rankings can occur by sector, size, country or even geographical area. Related to this, the report also supports those off-the-shelf tools for preparers to use to increase the quality of the disclosure they deliver. Reporting frameworks like the ones offered by the Climate Disclosure Project (CDP) and the Transition Pathway Initiative TPI are supported by the authors of the report.

Asset-level data, which were previously explained, are beginning to be at the forefront of physical risk management, for the simple reason that as satellite and sensors technology improves, more detailed and granular information can be gathered for companies' assessments. The authors recognise the UK as one of the leading countries for these technologies and their use for analytical purposes, and for this reason they advocate the creation of a "Green Fintech Centre" (GFC). This centre ought to provide the necessary know-how to assist the growth of green fintech by the public and private sector in different manners, for instance by offering satellite and remote sensing data, or computing power for big data analysis/machine learning, or even supporting the creation of algorithms or block-chain technologies that can help with the creation of asset-level databases and information-sharing between public and private sector actors.

Policy conclusions

The aim is to include the TCFD's recommendations in the UK corporate governance and reporting framework via a two-step process, i.e. creating a set of guidelines and referencing them within the body of existing rules and codes. These guidelines are expected to be published by 2018/2019, and then reviewed after two years (2020/2021). The inclusion of the recommendations should be a fairly smooth process if proper support from the UK Government and financial regulators is provided. The latter must stress that as the recommendations fulfil and respect international laws of climate-related risk, preparers will be able to satisfy their legal obligations and duties. Accordingly, the development of the guidelines should not only define their scope and the degree of transparency required from preparers, but should account for the differences among jurisdictions in treating the aspect of disclosure (take for example the Non-Financial Reporting Directive in Europe).

The TCFD Recommendations could be supported by the SFD Recommendations, that are designed to further the degree of disclosure (via bottom-up analyses) and inform investors on how companies are transforming their business models to increase their resilience towards the risks embedded in climate change but also to accommodate for the Sustainable Development Goals.

The integration of the recommendations requires support from public and private stakeholders: the framework indicates that the Green Finance Initiative should formally help the Government and regulators to prepare the guidelines, even by creating sector-specific forums that assist with their adoption and implementation. Governments and regulators are further advised to increase the availability of datasets from the British Land Registry, Environment Agency and relevant public bodies to support banks in the measurement of their clients' exposures to climate-related risks. Knowledge and training for designated seniors should be offered as expressed previously to ensure a sufficient level of competence in disclosing climate-related risks and opportunities. Publications of rankings and benchmarks should be endorsed by regulators to allow investors and other stakeholders to improve their capital allocation choices, and so should off-the-shelf tools (like the CDP and TPI indexes).

Finally, the disclosure framework could be complemented by the creation of a Green Fintech Centre that would stimulate green fintech development by public and private actors via the application of new technologies and the provision of knowledge and testbeds. This would place the UK in a leadership position across the world.

References

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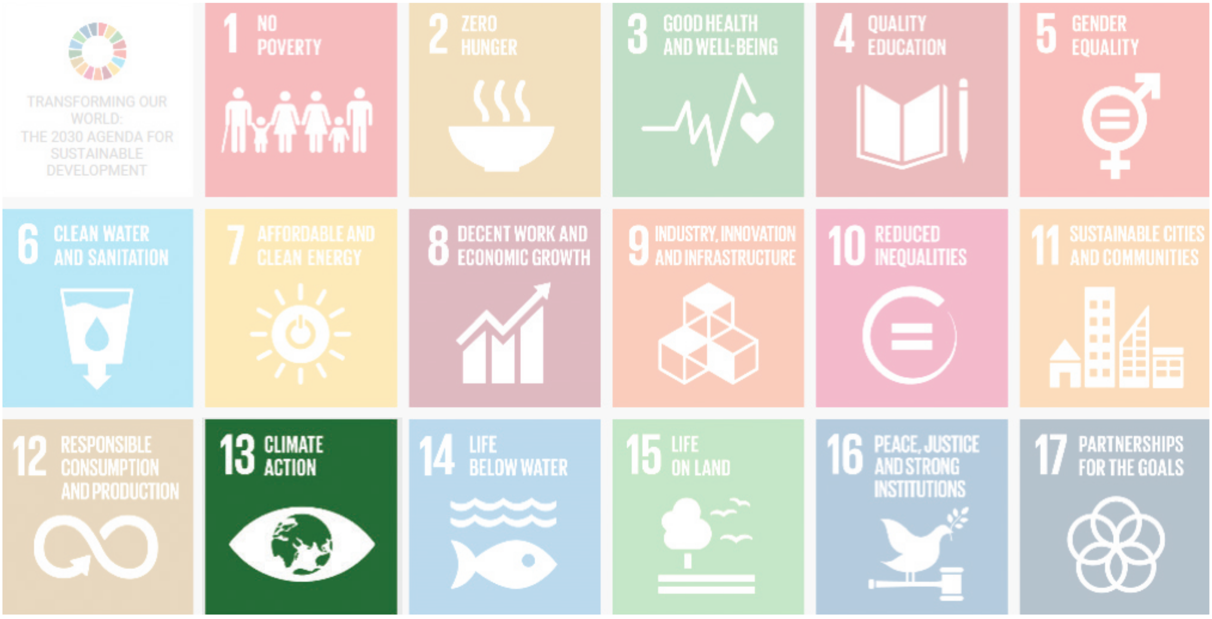

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