# Climate-related financial disclosures:

## Driving capital markets and corporate governors to address the climate emergency

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The proposal for a Reporting Standard for Climate-related Financial Disclosures will signal a step-change in New Zealand's climate change journey. While yet to be confirmed, it may apply as early as financial years starting in 2022. If so, affected parties will want to start planning now.

The proposed climate-related financial disclosure regime, announced by Hon. James Shaw, Minister for Climate Change, on September 2020, puts a spotlight on how climate change impacts are being addressed by business. The proposed disclosure regime will require specified entities to identify and report on the risks to their business by climate change, and their response.

The next steps are expected to be consultation by the External Reporting Board (**XRB**) on the details of a proposed standard, and by government on changes to the Financial Markets Conduct Act. XRB is anticipated to notify its work programme soon.

Meanwhile, investors are already moving to take account of climate impacts on private and public sector business, and capital markets.

## Climate impact is a financial issue

Climate change is now widely understood as a financial issue. Awareness is growing of how climate-based risks (and opportunities) may materially impact on business performance, position and prospects. Climate change impacts fall into three risks areas (refer right).

**Physical risks:** Beyond the obvious impacts of inundation, flooding and storm damage on infrastructure, the agriculture, horticulture, and fisheries sectors are likely to be impacted by volatile weather and warmer seas. Shifts will occur in viable land uses and fish stocks. The risk of bio-incursion (exotic pests) will increase. Energy and tourism sectors may also be affected as seasonal weather patterns shift or intensify, and biodiversity is impacted.

**Transition risks:** More subtle but equally powerful will be market forces and government responses to the threat of climate change, whether or not physical risks materialise.

- **Governmental action and regulation:** The Climate Change Commission's 2021 Draft Advice for Consultation[1] sets out how profound these changes may be, and how they will likely impact virtually all aspects of business in New Zealand either directly or indirectly. Overseas, comparable actions in the markets which buy New Zealand exports, or supply imports or investment will also impact the country's economy.

- **Investor and consumer reaction:** The reactions of investors and consumers is already affecting businesses, locally and overseas. Many investors and ratings agencies are showing a similar sensitivity, changing the cost of capital. Consumers are also asking questions about the carbon footprint of the goods and services they buy and changing their preferences. For some consumers this extends to questioning the social licence to operate, while others see new opportunities for growth emerging.

- **Stranded assets and changing business models:** Due to physical and transitional risks, the value of assets and of businesses are shifting. For example, a third of oil global reserves will remain unused if targets under the Paris Agreement are met, impacting the value of companies that extract, distribute or rely heavily on fossil fuels. Conversely the market capitalisation value of manufacturers of electric vehicles is increasing.

**Liability risks:** A current trend is activists and others to resorting to litigation. In New Zealand, in *Smith v Fonterra & others*, the plaintiff alleged that eight high profile businesses carbon emissions constituted a public nuisance, negligence or breach of other duties to him or his hapu. This case is under appeal. In Australia, in *McVeigh v REST*, the plaintiff sued his superannuation scheme for failing to have or disclose strategies to deal with climate related risk. The case was settled, reportedly on a basis that satisfied McVeigh's call for disclosure in future. In *Donovan v Commonwealth of Australia*, the plaintiff alleged that the defendant failed to adequately disclose, in the offering of sovereign bonds, the climate risk to which it is exposed. That case is ongoing.

## Disclosure will force transparency and adoption

According to the Cabinet Paper and Ministerial announcements last year, the regime is to be incorporated in the Financial Markets Conduct Act with amendments expected to be made during 2021. The XRB is tasked with developing a Financial Reporting Standard for Climate-related Financial Disclosures (**Standard**), setting out the detail of the requirements. Once confirmed, the Financial Markets Authority (**FMA**) will be responsible for independent monitoring, reporting and enforcement.

The Standard is expected to operate on a mandatory comply-or-explain basis, with the most likely approach being based on the Task Force on Climate-related Financial Disclosures (**TCFD**) framework, widely regarded as international best practice. This will be a challenge as no other country has yet converted the high level framework into a mandatory standard.

The TCFD approach is already being applied voluntarily overseas and by a small number of New Zealand entities. It sees entities undertake scenario analysis to identify how their business may be affected, and explain how they will measure emerging impacts, describing their approaches for managing risks and strategies for mitigation. Some include how they may benefit too.

*"It's likely that businesses covered by the new Standard will be required to make annual disclosures, covering governance arrangements, risk management and mitigation strategies."*

Compliance with the new Standard will be required for the major sources of capital in New Zealand including:

- all registered banks, credit unions, and building societies with total assets of more than $1 billion;
- all managers of registered investment schemes with total assets under management greater than $1 billion;
- all licensed insurers with total assets under management greater than $1 billion, or annual premium income greater than $250 million;
- crown financial institutions with total assets under management greater than $1 billion, such as ACC and the NZ Super Fund; and
- all equity and debt issuers listed on the NZX.

The Government estimates that around 200 organisations will be directly captured by the regime. The Minister for Climate Change has already indicated expanded compulsory coverage in time.

Pressure is also likely to mount for Crown and local authority owned businesses, especially those that compete with listed entities, and for other private enterprises to apply the Standard on a voluntary basis.

Astute business leaders will also see that a TCFD-style approach gives them a framework to demonstrate, should they later be challenged, that they have exercised the care, diligence and skill of a reasonable director – and discharged their duties.

Accordingly, the uptake of the Standard may well be much wider than those strictly required to comply, providing greater transparency as to which businesses will be most affected by climate change, and which have taken prudent steps to prepare – and which have not.

Those who chose not to disclose may find external stakeholders (eg customers, investors and lenders) make assumptions based on the disclosure of comparable entities in any event.

## Fund managers and other investors are shifting their money already – and this will only increase

The world's largest asset management firm, BlackRock announced initiatives to make climate change and other sustainability issues a cornerstone of its investment strategy in 2016. Its plans included increased offerings of sustainable funds, launching investment products that screen fossil fuels, and exiting investments in companies with high sustainability-related risks.

Its investment strategy has been significantly influenced by that approach. For example, in November 2020, BlackRock filed a substantial shareholder notice with NZX advising it now holds more than 5% of Meridian Energy – the first New Zealand listed company to voluntarily undertake TCFD-style disclosure.

This involved recognising that the global energy system will transition away from assets that may become uneconomic, obsolete or face a dwindling market, and turning towards those that are undervalued if climate change is considered – while remaining aligned with its mandate to maximise returns without undue risk. NZ Super has reported that more than NZ$1 billion of funds have been shifted. Recently ACC announced a similar strategy to decarbonise its investment portfolio.

The Government has also announced its intention, when default KiwiSaver providers are reappointed in 2021, to require the schemes to eliminate exposure to fossil fuel production to help the transition to a low-emissions economy.

*"Domestically, the NZ$30 billion NZ Super Fund has already implemented a multi-year strategy to be more resilient to climate change investment risk."*

Once major New Zealand fund managers are required to publicly report under the Standard, this trend is likely to accelerate for two reasons.

First, undertaking a TCFD-style analysis may raise the level of understanding of the exposure to climate risks that companies in the underlying portfolio face, leading to better decisions.

Secondly, as the fund managers' retail investors become aware of the exposure and the strategies for management, those investors may shift providers to better align with their own preferences, and fund managers may want to pre-empt such a move.

Likewise, the requirement for banks and insurers to undertake a TCFD-style analysis will most likely increase understanding about the exposure to climate risks of the companies to whom they lend, or who they insure, and how well they are managing those risks. Lenders will likely factor those risks into interest rates for some sectors. For example, some businesses with very high physical risks may become uninsurable and unable to borrow. On the positive side, those who can demonstrate Paris Agreement-aligned strategies may benefit from the growth in green finance markets.

For listed entities, the disclosure required by the Standard is also likely to interest wholesale and retail investors. For wholesale investors and equity analysts it will provide useful insights as to the likelihood and preparedness of the entity for the potential impacts listed above, encouraging changes in portfolios similar to those being undertaken by NZ Super, ACC and fund managers.

For retail investors, some will undertake a similar analysis to make decisions, and for others, the response may be more simplistic – does this company's approach align with my values and beliefs? TCFD-style disclosure (or its absence), even for unlisted banks and insurers, may attract employee, customer and activist attention, which will generate further pressure to take climate impacts in to account when developing their business.

## Conclusion

The proposed Reporting Standard for Climate-related Financial Disclosures will have a profound impact on private and public sector business and the capital markets when it comes in to force – perhaps greater than any other measure the Government has taken to date in relation to climate change.

It will require the boards and leadership teams of many of New Zealand's largest businesses, to undertake a systematic review of the implications of climate change for their businesses – if they have not done so already. The findings will influence strategic decision-making and investment decisions. Those businesses not legally required to comply with the Standard will increasingly comply "voluntarily" either because they consider it prudent and good business, or as a result of pressure from stakeholders.

With reporting on governance arrangements, risk management and mitigation strategies potentially required for financial years starting in 2022, forward looking entities should start preparing now by increasing directors' climate awareness, embedding climate issues into board structures and processes, and improving navigation of the risks and opportunities – that is the advice of the World Economic Forum (see right).

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[1] Published 31 January 2021, with submissions due by 14 March 2021. The final recommendations will be released on 31 May 2021. The Government has until the end of 2021 to accept the Commission's proposed budgets or come up with its own, and to create an emissions reduction plan for meeting the budgets.

## What should directors do now?

Whether driven to act by their understanding of the underlying economic drivers at play, or by the concerns of governments, and corporate regulators, mainstream director sentiment is shifting from "why would this be relevant to our business?" to "what are the implications for our business, how should we strategise and manage them, and what should we disclose to the market?"

These are not easy questions. While the direction of travel is clear, the timing, magnitude and location of impacts is uncertain.

The World Economic Forum's *How to Set Up Effective Climate Governance on Corporate Boards – Guiding principles and questions* provides one approach. It sets out eight principles, each with guiding questions to help identify and fill gaps.

**Principle 1 – Climate accountability on boards**
Climate change should enliven directors' governance duties as with any other issue presenting financial risks.

**Principle 2 – Command of the subject**
Boards should be composed of directors who collectively have sufficient awareness and understanding of how climate change may affect the business.

**Principle 3 – Board structure**
A board should determine how to most effectively embed climate into its board and committee structures.

**Principle 4 – Material risk and opportunity assessment**
The materiality of climate-related risk and opportunities in the short, medium and long term should be assessed at the company and understood by the board.

**Principle 5 – Strategic and organisational integration**
Once a board is aware of the extent climate change might drive material risks and opportunities for its operations, it can integrate climate-change considerations into the organisation's strategy.

**Principle 6 – Incentivisation**
A board should ensure that executive incentives are aligned to promote the long-term prosperity of the company, including climate-related targets and indicators.

**Principle 7 – Reporting and disclosure**
A board should ensure that material climate-related risks, opportunities and strategic decisions are consistently and transparently disclosed to all stakeholders – particularly investors and, where required, regulators.

**Principle 8 – Exchange of ideas**
Boards should maintain regular dialogue with peers, policy makers, investors and other stakeholders to share methods and stay informed about the latest climate relevant risks, regulatory requirements, etc.