CLIMATE FINANCIAL RISK FORUM GUIDE 2022

DISCLOSURES – MANAGING LEGAL RISKS

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Introduction/Scope

In 2021 the Climate Financial Risk Forum published “Disclosures – Managing Legal Risks” which formed part of a suite of broader guidance for financial institutions focused on climate disclosure. This document included an annex setting out in brief summary the different TCFD-aligned disclosure regimes under development in the UK at that time for listed companies, asset managers, life insurance companies and large unlisted companies, public interest entities and limited liability partnerships and the trustees of large occupational pension schemes.

In the context of a fast-moving and evolving climate transition landscape, it is perhaps unsurprising that there has been a number of developments in the UK disclosure regimes since October 2021, impacting all of the entities listed above. Many of these regimes were anticipated in October 2021 but have now been finalised or in some cases updated, including the regime applicable to asset managers.

This paper from the Transition to Net Zero working group provides an update of the 2021 annex to reflect such developments. Clarity around the legal expectations and implications of climate disclosures is clearly critical as disclosure expectations continue to heighten and more organisations issue climate disclosures. For financial institutions, it is important as firms issue their own disclosures, and as they assess disclosures of their clients/investees to engage with them on their progress and to make investment/financing decisions.

A separate paper will also be published in 2023 focusing on legal considerations relevant to transition plans. The items covered in this paper are informed by legal professionals in the CFRF, as well members from financial institutions to ensure the user and preparer perspectives are taken into account and it is of most practical value to the industry. This work will be coordinated with that of the UK’s Transition Plan Taskforce.

Annex

UK climate-related financial risk reporting

The UK's current regime for climate-related financial disclosures is based on the principal recommendations of the TCFD.[1] They have been developed by several different law and policy-making bodies and while each leverages the TCFD recommendations, there are differences in approach. These variations add complexity and a clear roadmap highlighting and justifying differences by sector may assist reporting entities.

Going forward, the UK Government has confirmed that it expects the existing climate-related financial disclosures to be replaced by the standards currently being developed by the International Sustainability Standards Board (ISSB)[2] which will form the backbone of corporate sustainability reporting in the UK[3].

1 Listing Rules

The Listing Rules require premium listed commercial companies for the reporting period commencing 1 January 2021, and issuers of standard listed shares and Global Depositary Receipts representing equity shares (excluding standard-listed investment companies and shell companies) for the reporting period commencing 1 January 2022, to include a statement in their annual financial report in respect of their compliance with the TCFD reporting methodology on a comply or explain basis.

1.1 Under the Listing Rules, these entities must set out in their annual financial report:

1.1.1 whether they have included climate-related financial disclosures consistent with TCFD Recommendations and Recommended Disclosures in their annual report financial and if so where;

1.1.2 if not, a description of which disclosures have been omitted, why and what steps they are taking to make such disclosures; and

1.1.3 where disclosures are set out in another document, a description of that document and where it can be found and an explanation of where and why the entity has adopted this approach.

1.2 In determining whether an entity's disclosures are consistent with TCFD Recommendations and Recommended Disclosures, the Listing Rules list a number of documents issued by the TCFD that they consider relevant. From 1 January 2022, this includes the updated TCFD Annex "Implementing the Recommendations of the Task Force on Climate-related Disclosures" and the TCFD Guidance on Metrics, Targets and Transition Plans, each published in October 2021. The 2021 TCFD Annex includes a number of updates to the 2017 TCFD Annex, in particular to address disclosure of actual and potential financial impacts of climate-related issues and updates to metrics and targets. The TCFD Guidance on Metrics, Targets and Transition Plans also includes a number of important updates on selection and disclosing of metrics and targets, the role of scenario analysis, transition plans and how this information may be useful to estimating the impact of climate-related issues on an entity's financial performance and position. In relation to transition plans (which are distinguished by the TCFD from adaption plans), whilst the TCFD was of the view that its existing recommendations already implicitly covered key aspects of transition plans, given the increasing focus on such plans, it determined that explicit guidance would be useful, including as to contents and timings for such plans.

1.3 Although the obligation in the Listing Rules is a "comply or explain" requirement, the FCA has made clear its expectation that reporting companies should ordinarily be able to make disclosures consistent with the TCFD's Recommendations and Recommended Disclosures other than where they face transitional challenges in obtaining relevant data or embedding relevant modelling or analytical capabilities. The FCA has subsequently

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1 Task Force on Climate-Related Financial Disclosures | TCFD) (fsb-tcfd.org)

2 Exposure Draft on IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information; Exposure Draft IFRS S2 Climate-related Disclosures

3 Letter from Lord Callanan to the International Sustainability Standards Board regarding their exposure drafts IFRS S1 and IFRS S2 - GOV.UK (www.gov.uk)

stated that it strongly supports a pathway to mandatory climate-related disclosures and expects to consult on doing so once the ISSB's new reporting standards have been introduced in the UK. This process is therefore expected to commence shortly.

1.4 A review has been undertaken by the Financial Reporting Council[4] and FCA[5] of the first 6 months of TCFD-aligned disclosures made by premium listed commercial companies pursuant to the Listing Rules. The results were released in two reports published on 29 July 2022. These reports, whilst positive as to the improvements made in climate-related disclosures, stress a number of areas of improvements expected in relation to reporting by all entities under the Listing Rules and reiterate certain expectations of the FCA in relation to compliance with the Listing Rules. The most common gaps were found to be in respect of: (i) strategy (c) on the resilience of strategy; (ii) risk management (b) on the process for managing risks; (iii) and metrics and targets (a) and (c) on metrics used to assess climate-related risks and opportunities and climate-related targets. The reports signal a clear expectation that the detail and quality and consistency of reporting is required to improve in the coming years. There are also reminders as to:

1.4.1 how disclosures may be useful in respect of the net zero commitments that companies are making. The FCA in particular encourages consideration of the TCFD's guidance on Metrics, Targets and Transition Plans referred to above and the need to ensure disclosures are not misleading

1.4.2 auditors and their responsibilities (as set out in the FRCs staff guidance[6])

1.4.3 the FCA's expectation that listed companies retain records to support statements made in their annual financial report and the detailed assessment of the company's disclosures against the TCFD's Recommendations and Recommended Disclosures.

2 Companies Act and Limited Liability Partnership requirements

For reporting years commencing on or after 6 April 2022, climate-related financial disclosure requirements apply to publicly quoted companies, large private companies[7] and large LLPs[8].

These requirements are based on the TCFD recommendations, but do not require the same level of detail as set out in the TCFD supplement guidance. Unlike the Listing Rules, these requirements are mandatory i.e. are not a comply or explain requirement. They also require disclosures to be included in the Strategic Report or, in relation to LLPs that don't prepare such a report, the Energy and Carbon Report of their Directors' Report[9].

Non-binding guidance has been published by BEIS underpinning these requirements[10].

The same enforcement regime will apply as for any existing non-financial information statement in a company's strategic report. Auditors' responsibilities are unchanged but are sufficiently broad to capture climate-related financial liabilities and impairments.

3 Asset Management requirements

ESG sourcebook

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4 News I Financial Reporting Council (frc.org.uk)

5 Review of TCFD-aligned disclosures by premium listed commercial companies | FCA

6 FRC Staff Guidance

7 The Companies (Strategic Report) (Climate-related Financial Disclosure) Regulations 2022

8 The Limited Liability Partnerships (Climate-related Financial Disclosure) Regulations 2022

9 Although see the FRC's report on the ability to use cross-referencing to other parts of the Annual Report and also the need to consider linking disclosures with other information disclosed in the Annual Report. Accountants I Accounting and Reporting Policy I Annual and Wider Corporate Reporting I Narrative Reporting I Guidance on the Strategic Report I Financial Reporting Council (frc.org.uk)

10 Mandatory climate-related financial disclosures by publicly quoted companies, large private companies and LLPs (publishing.service.gov.uk)

In December 2021, the FCA published the final rules for its TCFD-aligned disclosure regime for asset managers and certain asset owners.[11] The requirements are set out in a newly created Environmental, Social and Governance (ESG) sourcebook, which is found in the Business Standards section of the FCA Handbook.[12] It is anticipated that this sourcebook may be expanded in time to cover other ESG matters relevant to FCA authorised firms.

Scope

The new regime applies to asset managers that undertake any of the following activities:

(A) portfolio management (but note a special definition applies to this activity)

(B) managing a UK UCITS

(C) managing an AIF

provided the assets under management relating to the relevant activities are £5 billion or more (calculated on a 3-year rolling basis). The FCA will review this threshold after 3 years of disclosures. An extended meaning is given to portfolio management; in addition to covering discretionary investment management, certain private equity or private market business is also included.

Climate-related reports

Each asset manager is required to prepare and publish on their website annually a **"TCFD entity report"** (which discloses how the firm takes climate-related risks and opportunities into accounting in managing investments) and for each authorised fund or listed unauthorised AIF[13] that it manages a **"public TCFD product report"** (which contains disclosures about the climate-related attributes of the product). For unlisted unauthorised AIFs and other investment arrangements where the firm is providing the service of portfolio management (as defined above), the firm must make available to investors and clients an "**on-demand TCFD product report**". Such reports are referred to collectively as "**climate-related reports**."

Phased implementation

The FCA has introduced the requirements in phases:

3.1.1 Asset managers with assets under management of £50 billion or more became subject to the regime on 1 January 2022 and will be required to make their first disclosures by 30 June 2023 and subsequent disclosures by 30 June of each calendar year (Phase 1).

3.1.2 Asset managers with assets under management of £5 billion or more will become subject to the regime on 1 January 2023 and will be required to make their first disclosures by 30 June 2024 and subsequent disclosures by 30 June of each calendar year (Phase 2).

3.1.3 ESG Chapter 2 sets out the content requirements for each type of climate-related report[14]. A summary of some of the key elements is set out below.

General approach

The general approach is similar to that applicable to listed companies. Asset managers must ensure the climate-related financial information in their climate-related reports are consistent with the TCFD Recommendations and Recommended Disclosures and must reflect the supplemental guidance in the TCFD Annex. This comprises guidance for all sectors and specific guidance for the asset management sector. The FCA also specifies that it considers the following TCFD publications are relevant in determining whether a firm's disclosures are consistent

[11] PS21/24: Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers

[12] ESG 1 - FCA Handbook

[13] For example, an investment trust.

[14] ESG 2 - FCA Handbook

with the TCFD framework: (a) the TCFD Technical Supplement,[15] (b) the TCFD Guidance on Risk Management Integration and Disclosure,[16] and (c) the TCFD Guidance on Metrics, Targets, and Transition Plans. Unlike the current regime for listed companies, the FCA's regime for asset managers applies on a mandatory basis rather than on a "comply or explain basis."

Entity level vs product level differences

Where there are material deviations between the approach the firm takes at an entity level to the Governance, Strategy and Risk Management recommendations and the approach it takes for a particular product, it must provide an explanation for this in its TCFD entity report or cross-refer to an explanation in the relevant TCFD product report.

Cross-referencing other disclosures

When preparing its TCFD entity report, a firm may cross-refer to relevant disclosures made by its group or another entity in the group provided it explains the rationale for doing so and any material deviation in its approach to the TCFD Recommendations and Recommended Disclosures when compared to the approach of the referenced entity/group. Moreover, firms can include cross-references to a third party's climate reporting where it enables the firm to satisfy its disclosure obligation provided that the firm explains its rationale for relying on any third party's disclosures and any deviations between its approach and third party's approach.

Transition plans

While a firm is not required to produce transition plans (but see section 5 below), where it does so and it is headquartered or operates in a country that has made a commitment to a net zero economy (such as the UK's commitment in the Climate Change Act 2008 (as amended)), it is encouraged to assess the extent to which it has considered that commitment in developing and disclosing its transition plan. The FCA encourages a firm that has not considered such a commitment to explain why it has not done so.

Targets

If a firm has not set any targets to manage climate-related risks and opportunities, it must explain the reasons for not doing so in its TCFD entity report.

Climate-related scenario analysis

The TCFD entity report must set out the firm's approach to climate-related scenario analysis and how the firm applies climate-related scenario analysis in its investment and risk decision making process. Where reasonably practicable, the firm must give quantitative examples to demonstrate its approach to climate-related scenario analysis.

TCFD entity report compliance statement

The TCFD entity report must contain a compliance statement signed by a member of senior management. The FCA has clarified that this need not be a Senior Manager under the Senior Managers and Certification regime.

TCFD product reports: metrics and calculations

TCFD product reports are required to include: (a) Scope 1 and Scope 2 GHG emissions data, (b) Scope 3 GHG emissions data, (c) Total carbon emissions, (d) Carbon footprint and (e) Weighted average carbon intensity. The methodology for calculating these metrics is set out in the TCFD Annex; reference should be made to the Guidance on Metrics, Targets, and Transition Plans. Climate value-at-risk and portfolio alignment metrics must also be included where it is reasonably practicable to do so.

Product reports

[15] https://assets.bbhub.io/company/sites/60/2021/03/FINAL-TCFD-Technical-Supplement-062917.pdf

[16] https://assets.bbhub.io/company/sites/60/2020/09/2020-TCFD_Guidance-Risk-Management-Integration-and-Disclosure.pdf

A TCFD product report must also include:

- a qualitative summary of how climate change is likely to impact the assets underlying the relevant TCFD product under an "orderly transition", "disorderly transition" and "hothouse world" scenario; and
- a discussion of the most significant drivers of impact on the TCFD product.

Where the TCFD product has concentrated exposures or high exposures to carbon intensive sectors, the TCFD report must also include a description of the exposures and a quantitative analysis of the three transition scenarios referred to above.

Data considerations

As is to be expected, the FCA recognises that firms may encounter data and methodological challenges for a transition period. The FCA emphasises the need for firms to explain any limitations on their ability to disclose and set out the steps it is taking to address those limitations. Firms must not disclose metrics or quantitative scenario analysis or examples where there are gaps in the underlying data or methodological challenges that cannot be resolved through the use of proxy data or assumptions without the resulting disclosure, in the reasonable opinion of the firm, being misleading.

4 Occupational pension scheme requirements

New regulations have applied from 1 October 2021 imposing requirements for occupational pension schemes to align their governance processes and disclosures with TCFD recommendations. Statutory guidance has been published containing the detail underpinning the new regime. Where trustees deviate from the approach set out in the guidance, they are expected to describe their reasons for doing so in their TCFD report. The Pensions Regulator has also produced guidance on the governance and reporting of climate-related risks and opportunities[17].

The requirements apply in respect of seven areas: governance, strategy, scenario analysis, risk management, metrics, the selection of a target in relation to at least one selected metric, and as to trustee knowledge and understanding. Trustees must carry out scenario analysis, obtain GHG emissions data and other information relevant to their chosen metrics, use the data calculated and use those metrics to assess climate-related risks and opportunities and measure scheme performance against the trustee-set target "**as far as they are able**".

The regulations say that this means taking all such steps as are reasonable and proportionate in the particular circumstances, taking into account the costs (or likely costs) which will be incurred by the scheme and the time required to be spent by the trustees. This concept, which we have suggested drawing on for the purposes of other TCFD reporting, recognises that there may be gaps in the data trustees are able to obtain for these purposes of compliance. The statutory guidance also recognises that there are challenges in the quantification of climate risks with regard to particular investment products (for example, some sovereign bonds, contracts of insurance, asset backed structures and derivatives). The statutory guidance includes further details. The Regulator has said in its guidance that, where there are data gaps, it expects trustees to explain what efforts they have made to obtain the data, and to explain fully any gaps. The Regulator also says that trustees should outline their plans for overcoming those obstacles, as the quantity and quality of the data available is expected to improve over time.

This regime applies in a staged way to:

(i) Schemes with £5 billion or more in assets at the end of their first scheme year to end on or after 1 March 2020 and authorised master trusts will be subject to the governance requirements from 1 October 2021.

[17] Climate change governance guidance | The Pensions Regulator

(ii) Schemes with £1 billion or more in assets at the end of their first scheme year to end on or after 1 March 2021 will be subject to the requirements included in Part 1 of the schedule to the regulations (which includes governance, strategy, risk management, metrics and targets) from 1 October 2022.

Schemes will be required to publish their TCFD report on a publicly available website, accessible free of charge. The chair of trustees must sign the report. The TCFD report must be referenced in (but need not be included in) the Annual Report and Accounts and the Regulator must be sent a link to the scheme's TCFD report in its annual return.

On 1 October 2022 amendments to the above regime will become effective[18]. Pursuant to these amendments, pension schemes in scope will be required to calculate and disclose a metric describing the extent to which their investments are aligned with the climate change goal of limiting the increase in the global average temperature to 1.5 degrees Celsius above pre-industrial levels. This amendment shall apply for the scheme year which is underway from 1 October 2022.

5 Net zero commitments and climate transition plans

A growing number of financial institutions and companies are setting goals to achieve net zero emissions in their business and business relationships and developing climate transition plans to map out how they will change their strategy to achieve this. As of June 2022, around 702 companies from the Forbes 2000 list have announced a net zero target[19]. Many companies are using international methodologies, such as the Science Based Targets initiative[20] for developing their commitments and related plans.

These plans are becoming subject to increasing scrutiny and governmental focus. In 2021, the UK government published the Greening Finance Roadmap, committing to take action to help align UK financial flows with a net zero carbon economy. A significant building block of this strategy is the development of new Sustainability Disclosure Requirements (SDR), which will introduce requirements for decision-useful disclosures on sustainability across the economy. At COP26, the government confirmed that, as part of the new SDR rules, further steps would be taken to require the disclosure of climate transition plans. These additional steps will be informed by the work of the Transition Plan Taskforce (TPT). The TPT was launched on 25 April 2022 to develop a gold standard for transition plans. It has a two-year mandate and has announced its intention to publish a sector-neutral framework in relation to transition plans and accompanying guidance as well as sectoral guidance in 2023.

The Glasgow Financial Alliance for Net Zero have also published a number of documents setting out guidance and recommendations in relation to transition plans, most recently "Expectations for Real-Economy Transition Plans"[21].

With these developments in mind, as noted above, the CFRF will be publishing a note on legal considerations in relation to climate transition plans in 2023.

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18 Occupational Pension Schemes (Climate Change Governance and Reporting) (Amendment, Modification and Transitional Provision) Regulations 2022 (SI 2022/733)

19 Net-Zero-Stocktake-Report-2022.pdf (edcdn.com)

20 https://sciencebasedtargets.org/

21 Transition planning | Glasgow Financial Alliance for Net Zero (gfanzero.com)