An opportunity for the EU to raise the bar on climate-related financial disclosures

Legal & General
INVESTMENT MANAGEMENT

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WHY WE NEED IMPROVED CLIMATE-RELATED FINANCIAL DISCLOSURES

We believe that recognising the potential risks from climate change and providing solutions for a low-carbon transition is firmly part of our fiduciary duty when managing our clients' assets. **However, in order for markets to accurately price in climate risks, we need climate-related financial disclosures from investee companies to significantly improve.** Investors need accurate information in order to efficiently price risks and allocate capital, ensuring that the cost of the low-carbon transition is managed in an orderly way.

As a large index investor, climate change is a pivotal risk that we look for portfolio companies to manage. **It is important for us to ensure that the management of the companies we invest in take public ownership of the climate-related risks facing their businesses.** Climate disclosures require company leadership teams to conduct a thorough analysis of risks, and should help drive strategic thinking at the very top about the business implications of the low-carbon transition.

Our experience of assessing companies on their governance and management of climate risks tells us that relevant and consistent reporting remains insufficient. Over the past two years, LGIM has spent significant time engaging with 84 global companies, including 10 Oil & Gas majors, as part of our Climate Impact Pledge. During the course of this engagement, we have reviewed annual reports and other public disclosures from all 84 companies, in order to assess them on over 100 different climate-related metrics.

We believe that the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) will help progress the quantity and quality of disclosure. For this reason, we strongly supported the release of the recommendations. However we also note that even those companies that have begun to report in-line with the TCFD do not comprehensively disclose climate-related financial information in their annual reports. Investors currently have to source the vast majority of their climate data from third party providers, much of which is unverified.

We therefore also very much welcomed the establishment of the Technical Expert Group (TEG) by the EU Commission, which has been tasked with assisting in the development of guidance to improve corporate disclosure of climate-related information in the union. The guidelines refer to the non-financial information companies with at least 500 employees are currently required to include in their management reports. We agree that it is important to align these guidelines with existing and developed practices and **we believe that the TEG's recommendations can play an important role in closing the gap on key areas of disclosure that are lacking, even after implementation of TCFD guidelines.**

KEY AREAS TO FOCUS ON IN CLOSING THE DISCLOSURE GAP

There are areas of climate disclosure that are currently missing from public reporting and that we believe are key to enabling the accurate pricing of risks, and to encouraging management to take ownership of climate strategies. It is data which investors cannot assess from the outside, but if published would offer important insights into how the company is likely to fare financially in the low carbon transition.

Below we outline suggestions for what we believe are some of the most essential elements for regulators to consider, as frameworks for corporate climate disclosure are developed. These fall under three main categories:

1. Mandatory climate stress testing
2. Emissions impact and future trajectory
3. Preparedness for the new economy

It is important to note that the suggestions below should not be interpreted as fully formed policy recommendations. Rather, they are intended to provide an indication of the type of information institutional investors seek from portfolio companies. This would enable more informed investment decision-making as the world transitions to a low-carbon economy.

1. Climate stress testing

While many companies, particularly those operating in extractive industries, disclose their use of climate scenario analysis, these scenarios are very much a black box. Investors have little to no insight into the assumptions that inform them, and whether these in turn are sufficiently robust.

Therefore we believe that a mandated stress test, with parameters and methodology defined by regulators would be one of the most impactful measures to improve corporate climate disclosures. Regulators should be clear about the assumptions required in this stress-test, or else, if there is flexibility, then companies must be required to disclose the assumptions that they make. In our view, such a test should:

a) Define a set methodology by sector

b) Require companies to disclose the results

c) Require outputs to be independently audited for its compliance with regulations, and include an auditor's statement on whether or not the analysis has been conducted in compliance

This suggestion is not without precedent. The Bank of England currently mandates stress testing for the banking industry, where analysis inputs and parameters are defined by the regulator. This logic could be applied to climate change for some of the most emission-intensive industries, such as Oil & Gas, mining, utilities and transport.

The design of such stress tests would be for regulators to define. However, crucially we would expect analysis to incorporate the **price elasticity of demand**, including the sensitivity of companies' demand/planning assumptions to carbon pricing levels. We note that the International Energy Agency's 'two degrees scenario' assumes a carbon price of $140 in most Organisation for Economic Co-operation and Development (OECD) countries by 2040.

Example: Fossil fuel extractives

- What are the mean and median pricing assumptions currently used by the company to plan capital allocation?
- If a meaningful carbon price is introduced in all the company's key markets, demand for hydrocarbons would likely be reduced; what would the impact be on planning assumptions, including commodity pricing?.
- What is the sensitivity of the projects the company has already committed capital to, both developed and undeveloped reserves, from a reduction in demand and commodity prices of X%?

2. Emissions impact and future trajectories

By mandating meaningful reporting of greenhouse gas emissions, company management would be forced to take public ownership of both the climate impact of their business, and enable an internal analysis of what the financial impact of a meaningful carbon pricing regime would be.

Below we offer our suggestions on the greenhouse gas related metrics we believe companies should be required to measure and report.

- Companies should be mandated by regulators to disclose the carbon emissions embedded in their products. In practice, this would mean a requirement to disclose sector-relevant scope three, indirect carbon emissions. Depending on the industry in question, this includes:
  - Purchased goods and services (upstream scope three)

- Use of sold products (downstream scope three)
- Investments (downstream scope three)
- Waste/end of life treatment of sold products (up and/or downstream scope three)

- Disclosure of emissions reduction targets. Targets should include information on the reduction in **absolute** emissions the company expects to achieve, and clearly demonstrate the extent of alignment with a well-below 2°C pathway, the stated aim of the Paris Agreement.

3. Preparedness for the new economy

As the TCFD recommends, we believe it is important for companies to be transparent with regards to the capital expenditure (capex) and operating expenditure (opex) allocated to low-carbon activities or products.

However the percentage of capex allocated to renewable energy (for example) is not on its own a reliable indicator of climate risk, if the company is not also disclosing in parallel whether and how much it is investing in high-emission activities.

Therefore we believe improving disclosure around capex and opex planning is central to providing investors and the wider market with an accurate indicator of how companies are preparing for the low-carbon transition. It would also require company management to take public ownership of the viability of their business plans in an emissions constrained economy. To improve transparency, we suggest companies should be required to disclose the metrics below:

- Breakdown of capital expenditure in a way which clearly quantifies:
  - The level of investment going to activities or products compatible with a low carbon transition
  - Conversely: what is allocated to products or services detrimental to a low carbon transition
- Operational expenditures, for example allocated to energy/water efficiencies;
  - Percentage of R&D spend allocated to low carbon/resource efficient technologies
  - Application of an internal price on water. Currently, companies' business-as-usual assumptions are most often that water is close to a free resource
  - Population growth and climate change risks changing this in certain geographies, and we believe companies should begin accounting for the financial impacts
- Breakdown of revenue streams in a way which clearly identifies:
  - Revenue derived from activities or products compatible with a low carbon transition
  - Conversely: revenue derived from activities or products that are detrimental to a low carbon transition/not aligned with a low-carbon scenario

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