Sustainable finance in emerging markets and the role of securities regulators

CDSB response – 11th June 2019

The Climate Disclosure Standards Board (CDSB) welcomes the opportunity to respond to the *Independent review of the Financial Reporting Council: initial consultation on recommendations*[1] (hereafter referred to as "the Consultation").

CDSB an international consortium of business and environmental NGOs catalysed by the World Economic Forum in 2007. We are committed to advancing and aligning the global mainstream corporate reporting model to equate climate change and natural capital information with financial information. We do this by offering companies a framework for reporting climate change and environmental information with the same rigour as financial information. In turn this helps them to provide investors with decision-useful environmental information via the mainstream corporate report, enhancing the efficient allocation of capital. Regulators also benefit from compliance-ready materials. Recognising that information about natural capital and financial capital is equally essential for an understanding of corporate performance, our work builds the trust and transparency needed to foster resilient capital markets.

The CDSB Framework is used by large listed companies global and is referenced in government guidance to reporting regulation in HM Government's Environmental Reporting Guidance to the UK Companies Act 2006[2], the EU Commission Guidelines on Non-Financial Reporting, and stock exchange guidance in London, New York, Australia, Singapore, Egypt, Santiago de Chile and elsewhere. CDSB has also contributed to the work of the UN Sustainable Stock Exchanges Initiative through its working groups on disclosure, green finance and financial regulators. CDSB also hosts the TCFD Knowledge Hub on behalf of the G20 Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), which helps report preparers to find the resources they need to understand and implement the TCFD recommendations. CDSB is also a member of the FRC's Stakeholder Advisory Panel.

As evidence of the importance to respond to ESG risks and opportunities at pace and scale grows, securities regulators must play a leading role to address these in order to protect and safeguard the market, investors and society at large. We therefore welcome the opportunity to highlight the importance of these issues as part of this Consultation, which seeks to create, among others, a forward-looking regulator that seeks to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term.

Our comments in full are provided below. Please do not hesitate to contact us for further information.

Kind regards,

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[1] https://www.gov.uk/government/consultations/independent-review-of-the-financial-reporting-council-initial-consultation-on-recommendations
[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/791529/Env-reporting-guidance_inc_SECR_31March.pdf

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Responses to the Consultation Questions

Chapter 1 – FRC structure and purpose

Q1. What comments do you have on the proposed objective set out in Recommendation 4?

Our reading of the FRC's objective puts too much emphasis on narrowly defined *financial* information. Recognising that shareholders and potential investors of a company use not only financial, but other information that relates to financial performance, we suggest that the objective of the new regulator be amended as follows:

"To protect the interests of users of ~~financial~~ corporate information and the wider public interest by setting high standards of statutory audit, corporate reporting and corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards."

Q2. What comments do you have on the duties and functions set out in Recommendations 5 & 6?

We are concerned that the new regulator may fall into the same pitfall as the FRC when it comes to climate change and environmental information if its duties do not include a more specific reference to such matters. When asked about whether the FRC conducts, or plans to conduct, supervision of corporate reporting related to climate change-related and other ESG reporting requirements under the Companies Act 2006 (as amended), the FRC has stated that it does not believe that it have a clear mandate to do so.

Given the increasing evidence of the potential financial impact of climate change and other ESG risks on corporate performance, the duties of the FRC should be clearer on the need to not only focus on purely financial reporting, but to incorporate a wider definition of corporate reporting into its objective.

Given that the majority of issuers and other regulated entities do not currently take sufficient account of ESG-specific issues[3], it is important to ensure that there is a supervisor in the UK with the clear mandate to oversee such reporting. While the FRC has done much to promote ESG reporting through its Strategic Reporting Guidance and through other guidance by the FRC Reporting Lab, it has been open about the fact that it does not see sufficient mandate to supervise such reporting, because it is first and foremost the *Financial* Reporting Council.

The lack of sufficient attention to ESG issues results in a less than complete picture of risk exposure, thus affecting the market's ability to price these risks appropriately, in turn exposing risks to financial stability more broadly.

There is growing evidence that supports the financial risks associated with climate and other ESG risks. In the case of climate change for example, research published by the Prudential Regulatory Authority's report on the impact of climate change on the UK insurance sector[4], as well as the report of the European Systemic Risk Board's Advisory Scientific Committee on the transition to a low-carbon economy and systemic risk[5] have both highlighted the potential financial impacts of this issue. While the UK has made significant progress in implementing mandatory climate change, environmental and other ESG requirements, the lack of supervision of such reporting has left the quality of information provided to investors with much to be desired.

As such, we strongly recommend either:

- Adding a specific duty on climate, environmental and other ESG-related financial reporting; or

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[3] See for example CDSB research on implementation of climate change and environmental reporting, as mandated in the Companies Act 2006, as amended by the Companies, Partnerships and Groups (Accounts and non-financial reporting) Regulations 2016: CDSB (2018) First Steps: Corporate climate & environmental disclosure under the EU Non-Financial Reporting Directive. [PDF]. Available from: cdsb.net/NFRreview.

[4] Bank of England Prudential Regulation Authority (2015). The impact of climate change on the UK insurance sector. [PDF]. Available from: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/impact-of-climate-change-on-the-uk-insurance-sector.pdf?la=en&hash=EF9FE0FF9AEC940A2BA722324902FFBA49A5A29A

[5] European Systemic Risk Board (2016). Too late, too sudden: Transition to a low-carbon economy and systemic risk. [PDF]. Available from: https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf

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- Amending the first duty as follows:
Is forward-looking, seeking to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term, including those related to climate change, environment and wider ESG matters;

While it may seem unorthodox to highlight a single set of issues in the duties of the new regulator, the past has provided a clear indication that it is necessary to do so in order to avoid a gap in the supervision of such reporting. Both the Financial Conduct Authority and the Prudential Regulatory Authority is making significant progress on incorporating climate-related reporting in their supervisory activities, while the FRC has lagged behind on this issue, focusing on purely voluntary guidance due to its unclear mandate in this area.

Q3. How do other regulators mitigate the potential for conflict between their standard setting roles and enforcement roles as set out in Recommendation 14?

CDSB has no comments on this matter.

Q4. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

CDSB has no comments on this matter.

Chapter 2 – FRC: Effectiveness of core functions

Q5. How will the change in focus of CRR [Corporate Reporting Review] work to PIEs [Public Interest Entities] affect corporate reporting for non-PIE entities?

We do not see sufficiently strong arguments behind Recommendation 27. Restricting CRR activities solely to PIEs could create a dangerous environment where non-PIE entities would in effect be left unsupervised. This would substantially reduce the powers of the new regulator when it comes to corporate reporting, rather than strengthen it.

Looking at climate change and environmental reporting under the Companies Act 2006 (as amended) requirements as an example, we see a clear need for a feedback loop between **all** entities and the regulator. The CRR is an excellent vehicle for reporting entities to receive constructive feedback on their reporting from an authoritative and expert entity, regardless of size or other categorisation.

If non-PIE entities are exempt from CRR, it could result in less attention given to their reporting, resulting in lower quality reports. This could negatively impact its shareholders and potential investors, who would receive less decision-useful information, as well as less reliable information on the risk exposure of the company. In return, it is not unreasonable to expect that investment into these companies could reduce as a result of lower-quality or less trustworthy information.

In addition, many ESG issues are not directly correlated to whether an entity is a PIE or not. In fact, as much as 80% of the emissions related to a large entity's activities stems from smaller suppliers in its supply chain[6].

In conclusion, we have strong concerns that implementing Recommendation 27 could decrease the quality of, and trust in the reported information by non-PIE entities, potentially resulting in a reduction in investor protection by the new regulator, as well as less investment in non-PIE entities. As such, we do not agree with this recommendation.

Q6. What are your views on how the pre-clearance of accounts proposed in Recommendation 28 could work?

While there should be an established process for regulated entities to engage with the new regulator, having a fee-based pre-clearance process of the treatment of novel and contentious matters in accounts in advance of

[6] See for example McKinsey (2016) Starting at the source: Sustainability in supply chains. [Online]. Available from: https://www.mckinsey.com/business-functions/sustainability/our-insights/starting-at-the-source-sustainability-in-supply-chains

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their publication could pose a conflict of interest, whereby the new regulator would feel bound by such a fee to pre-clear reports that do not meet the needs of their readers.

Funding sources for the new regulator should be diversified and, wherever possible. be provided by either Government or a wide range of market actors to avoid a potential conflict of interest when acting to supervise corporate reporting.

A solution to this issue could be to establish a process for engagement with the new regulator on the treatment of novel or contentious issues in accounts to inform the new regulator's standard-setting activities and/or its activities related to providing guidance to the market, similar to the work of the FRC Reporting Lab.

Q7. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We strongly support the wider, risk-based approach for CRR outlined in Recommendation 29. Such an approach could ensure a more comprehensive review of corporate reporting, based on the best available research related to material risks.

While we understand the concern by the market about the amount of guidance produced by the FRC, we would like to note that much of the FRC's guidance is regarded as best-in-class internationally and some have been referenced or adapted in other jurisdictions. We also note that, in the case of ESG reporting where the FRC did not feel it had sufficient powers to take stronger action, guidance was used as a stopgap to provide some authoritative direction for the market. It is however not unreasonable to infer that, with its improved remit and powers, the new regulator should have less need to produce guidance.

Chapter 3 – Corporate failure

Q8. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We strongly support Recommendation 44 and applaud the FRC's swift action to set up a robust market intelligence function to identify emerging risks at an early stage. We will make ourselves available to this function whenever we believe we can be of service to support its work.

With regards to Recommendation 52 on viability statements, the Review should also consider viability concerns related to climate change-related matters. Here, the recommendations[7] of the Task Force on Climate-related Financial Disclosures, could be useful, namely Strategy recommendations b) and c):
b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy and financial planning.
and
c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2ºC or lower scenario.

Chapter 4 – The new regulator: oversight and accountability

Q9. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

CDSB has no comments on this matter.

[7] Task Force on Climate-related Financial Disclosures, 2017. Final Report - Recommendations on the Task Force on Climate-related Financial Disclosures. [Online]. Available at: https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf

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