AFME response to Targeted consultation on the update of the non-binding guidelines on non-financial reporting

20 March 2019

AFME and its members welcome the opportunity to respond to the European Commission's *Targeted consultation on the update of the non-binding guidelines on non-financial reporting ("Consultation Document" or "CD")* aimed at collecting views from interested stakeholders on the possible content of the new supplement to the NFRD Non-Binding Guidelines specifically with regard to the reporting of climate-related information. We appreciate and support that the Commission continues to explore ways to ensure that issuers and users of climate-related information are comfortable with the proposed guidelines, which will be important to ensure the efficient implementation of the recommendations.

As also set out in *AFME feedback on the TEG's report on Climate-related Disclosures*[1], we are supportive of the objective to develop better voluntary disclosures, based on materiality and strategic outlooks, to improve investment and lending decision-making through the Non-Financial Reporting Directive, the industry-led FSB TCFD work as well as additional existing national, EU-based and international frameworks. We therefore provide our comments to different sections of the Consultation Document as follows below.

GENERAL

We are pleased that the proposed guidelines were prepared with an understanding that "methodologies and best practice in the field of climate-related reporting are evolving fast" and that "a flexible approach is necessary", encouraging the uptake of innovation and scientific approaches to deliver on information needs of the relevant stakeholders.

It is also very encouraging that the guidelines were developed considering a principle of proportionality which intends to "recognise that the content of climate-related disclosures may vary between companies according to a number of factors, including the sector of activity, geographical location, the nature and scale of climate-related risks and opportunities, and the size of the company".

However, although we understand the merits of integrated reporting and that companies should be encouraged to integrate climate-related information with other financial and non-financial information in the longer term, we believe that at this earlier stage companies should be able to report climate related-information on a stand-alone basis due to currently limited capabilities of the industry to access and assimilate such information with financial and other corporate reporting.

CHAPTER 2.1 Materiality

AFME notes that the proposed guidelines incorporate the requirement to disclose climate related information if and to the extent that such information is necessary for an understanding of the company's development, performance and position (consistent with the concept of financial materiality and respective TCFD recommendations) as well as the impact of the company's activities on climate (consistent with the broader NFRD requirements). While we understand that this concept of "double-materiality" would be sensible from the perspective of a broader group of stakeholders (which the NFRD is aimed at), we would like to emphasise that the reporting practices on such impact are not yet clearly developed. We note that, although the TCFD recommendations regarding the impact of climate change on the company's financial position and

[1] https://www.afme.eu/globalassets/downloads/consultation-responses/afme-sus-response-to-teg-disclosures-report-feb-2019.pdf

performance have been implemented by more than 500 firms globally, according to the TCFD's status report published in September 2018[2], in general, industries, including the banking sector, are still at the beginning of the journey towards firmly established frameworks and practices on quantifying the financial materiality of climate change. Identifying and quantifying risks related to climate change as systemic risks presents even more complexities and challenges. With this in mind, we believe that firms should be encouraged to provide the respective disclosures but with the view that the quality of information provided will improve over time.

The guidelines state that "*When determining whether climate is a material issue, companies may wish to refer to one or more publicly available materiality matrices developed to guide companies in this regard*". It would be helpful to indicate some non-prescriptive examples of such matrices.

Additionally, consistent with our feedback to the TEG's Report on Climate-related Disclosures (TEG's Report) it would be helpful if the guidelines clarified that, in relation to the climate-related financial disclosures, firms must continue to have the right to make judgments about what is relevant and material to their investors and creditors, and thus to be able to define materiality thresholds for physical and transition risks. We note that considering materiality in the investment and lending process requires judgement and an integrated approach ensuring that the focus is on customers and on the issues with the largest impact. This approach would help to avoid information overload or excessive disclosures that would rapidly become of little value to users.

CHAPTER 2.2 Structure of the proposed disclosures

We generally welcome the approach where that the proposed disclosures are divided into two types focusing on disclosures that should be considered by the company if climate-related information is necessary for an understanding of its development, performance, position and impact of its activities (Type 1) and additional disclosures that companies may consider in order to provide more enhanced information (Type 2). We welcome the flexibility provided by this approach that would support companies in determining the relevant and material disclosures. We would also welcome additional guidance of the level of prescriptiveness of Type 1 disclosures, clarifying whether entities would still need to make a statement in their reporting as to how they considered Type 1 disclosure requirements even when they chose to not disclose such information.

We would also recommend a phase approach targeting the corporate sector first and then moving on to financial institutions because the latter are dependent on the former to assess their own climate related risks.

CHAPTER 2.3 Climate-related risks, dependencies, and opportunities

AFME agrees that companies should be encouraged to integrate information on natural, human and social capital in their reporting on climate-related issues. However, we note that, as of the moment, methods for assessing natural capital dependencies are at a very early stage of their development, therefore a flexible approach to disclosing such information is welcome allowing industries to prepare qualitative disclosures only with the view of improving and providing quantitative information in the longer-term.

CHAPTER 2.4 Links with recognised reporting frameworks and standards

AFME strongly supports the alignment of the NFRD with the TCFD recommendations generally exhibited in the Consultation Document, over a sensible timeframe. We also appreciate that the CD notes the consistency with other existing reporting frameworks which will be fundamental to the quick, efficient and wide adoption of the new guidelines. In particular, the KPIs / metrics and targets will be key for businesses to track, assess and manage climate-related risks and opportunities whilst giving investors and lenders the necessary data to

[2] https://www.fsb-tcfd.org/wp-content/uploads/2018/09/FINAL-2018-TCFD-Status-Report-092618.pdf

make informed investment and lending decisions. Also, AFME finds the juxtaposition of NFRD elements and TCFD recommendations in Annex II of the CD very helpful.

We would like to note though that the TCFD recommends that disclosure is included in financial filing while NFRD's vision was primarily around non-financial reporting. Therefore, it is important to ensure that a clear focus is kept on the TCFD requirements in the development of a robust climate-related disclosure framework.

CHAPTER 3. PROPOSED DISCLOSURES

CHAPTER 3.1 Business Model

AFME believes that disclosure needs to balance the risk and opportunity presented by the transition to a low carbon economy, which we think the proposed guidelines do.

We note that climate change risk manifests itself in multiple ways and through many channels and it will take a number of years to collect and collate the necessary customer, economic and scientific data and develop the systems and modelling capabilities. Therefore, we support the fact that the Commission focuses on Type 1 disclosure requirements, which are generally aligned with the TCFD recommendations to allow the industry to align and evolve. We note that the Type 2 disclosure recommendations on a company's business model at this stage would go beyond the TCFD recommendations and would reach a level of granularity that could pose a problem for reporting entities due to the additional reporting burden and, more importantly, lack of available data to support the preparation of the disclosures.

CHAPTER 3.2 Policies and Due Diligence Processes

We appreciate the clarification provided in the proposed guidelines compared to the TEG's Report in relation to the disclosure of the degree of climate competency that exists at board and management level adding that it could be "expertise to which the company has access" that can be disclosed rather than the expertise present at the board level directly.

CHAPTER 3.3 Outcomes

We agree with the use of metrics and targets, but we expect the metrics and tools to evolve and mature over time to incorporate climate change risk to inform companies' strategies and risk appetite. We reiterate that flexibility and a non-prescriptive approach, which the guidelines seem to provide, will provide the opportunity to ensure the right outcomes.

CHAPTER 3.4 Principal Risks and their Management

AFME notes that, given the inherent uncertainties of climate change impacts, the assessment of such impacts should capture mid- to long term risks only in qualitative terms.

CHAPTER 3.5 Key Performance Indicators

We believe that the guidelines generally capture the right KPIs. We note though that the availability of client level, industry and economic climate change-related data are factors that are likely to impede the pace and quality of climate-related analyses and disclosures.

For the financial sector, the quality of disclosure is heavily dependent on the robustness of disclosure by banks' clients. Therefore, firms' ability to provide Scope 3 information is dependent on the engagement with their clients but also robust frameworks, to drive the granular reporting.

AFME notes that the CD proposes disclosure of KPIs based on the share of activities as measured by financial metrics (e.g. percentage of turnover, investment, CapEx/OpEx) that contribute to mitigation of or adaptation to climate change. Although we agree that the EU Taxonomy Regulation is aimed at defining environmentally sustainable economic activities, we note that it would be important to not base and measure the KPIs solely on the basis of the environmentally sustainable economic activities as defined by the Taxonomy. This is because we anticipate that there will be a substantial transition process during which the activities will be moving to more sustainable outcomes and we believe the KPI process should reflect this. Therefore, we note that whilst the Green Debt Ratio KPI (Table 6 – Key Performance Indicators (Type 2) would be useful, companies should be allowed to establish and disclose indicators capturing a broader range of activities that might not be necessarily aligned with the EU Taxonomy definitions or the Green Bond and Loan Principles.

ANNEX I: Sector-specific disclosures for banks and insurance companies

AFME appreciates that additional sector-specific disclosure guidance was provided by the Commission for banks and insurance companies. We understand that the Commission's Action Plan on Financing Sustainable Growth "places a particular emphasis on the systemic importance of the financial sector in enabling the transition to a low-carbon and climate-resilient economy", and we understand the importance of the financial sector in the achievement of this objective. We also agree that "banks and insurance companies are both providers and users of climate-related information", and although we note that the CD has very rightly placed a large focus on the financial sector, equal weight needs to be paid to the non-financial sector, which may be unfamiliar with forthcoming disclosure requirements. As noted within our previous comments, the quality of banks' data relies on the quality of their clients' data. The prerogative therefore should be on facilitating and engaging with the non-financial sector to deliver more meaningful disclosure.

We note that the sector-specific disclosures have not been categorised into Type 1 vs Type 2 disclosures, thus it would be helpful to obtain clarity on the level of their prescriptiveness.

Additionally, AFME notes that the guidelines do not provide specific sectoral disclosure guidance for asset managers and for asset owners, which appears to be not in line with the TCFD stating that "the TCFD recommends all companies with public debt or equity as well as all other organisations, <u>especially asset managers and asset owners</u>, implement its recommendations…" At the same time, the CD's guidelines for banking and insurance sectors contain disclosure recommendations in relation to asset management activities. It is unclear why banking institutions would be expected to provide the disclosures on their asset management activities whilst separate asset management companies seem to have been excluded from the scope, potentially creating the risks of disproportionate reporting burden for the banking sector. Therefore, we would welcome a clarification on the scope of the proposed sector-specific disclosures.

ANNEX I: Business Model

AFME would like to reiterate the previously stated point that reliable, high quality data from the corporate sector would be fundamental in meeting the disclosure requirements for banks, especially those stated paragraphs 2 and 3 of Table "Disclosure on Business Model":

- *Disclose whether and how the institution takes into consideration the fact that its counterparties take climate related risks into account.*
- *Describe how the assessment of climate-related risks and opportunities are factored into relevant investment, lending and insurance underwriting strategies and how each strategy might be affected by the transition to a lower-carbon economy.*

ANNEX I: Policies and Due Diligence Processes

AFME notes that the section focuses on climate change mitigation and does not include recommendations in relation to policies and due diligence processes on managing physical risks and climate change adaptation financing and thus we would welcome such guidance.

ANNEX I: Outcomes

We note that reporting on the outcomes would be possible after the policies and due diligence processes noted in Section 2 of Annex I have been fully established and operationalised.

ANNEX I: Risks and Risk management

AFME welcomes the proposed guidelines and is supportive of the principle of integrating financial and non-financial reporting in the longer-term perspective, however, notes that at this stage the availability of client level, industry and economic climate change-related data presents obstacles to firms' ability to embed climate change within their risk management processes and integrate financial with non-financial disclosures. Companies will need to review their internal controls and systems for gathering non-financial qualitative and quantitative data. As a result, we foresee a multi-year journey for firms to collect customer data, establish relationships with external data providers and to integrate this with existing systems and models. This information will be essential to insightful statements of risk appetite and the quality of respective reporting.

We do not support recommendations on the separate disclosure of volumes of collateral exposed to climate related risks. This information is already integrated in financial instrument impairment models for the purpose of financial reporting and any material impact of climate related risks on the company's financial position and performance would be captured and reflected in the provisions for impairment of the financial instruments (for example, loans). We thus believe these additional disclosures will not provide significant value to the users and should not be included in the recommendations. Additionally, were the recommendations on collateral disclosure to be remained in the guidelines, we would welcome better clarity on the definition of "real estate collaterals highly exposed to transition risk", i.e. whether there is any relationship with measuring the energy efficiency of the property via Energy Performance Certificates.

ANNEX I: KPIs

As noted above, we believe that the proposed KPIs are generally sensible in terms of their informativeness and reporting capabilities, however AFME would welcome a clarification on the definition of "bank's equity portfolio" as noted in the table summarising the recommended KPIs.

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About AFME:

AFME (Association for Financial Markets in Europe) advocates for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society. AFME is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues. AFME aims to act as a bridge between market participants and policy makers across Europe, drawing on its strong and long-standing relationships, its technical knowledge and fact-based work. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.