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COP26 HIGHLIGHTS PRESSURES ON CORPORATES AND FINANCE TO GO GREEN

Governance, Sustainability & Society – Part of the Horizon Scanning series

As the UN's global climate change conference COP26 draws to a close, it has sharpened the focus on efforts to transform business and the financial system, including through global sustainability standards, mandatory climate reporting and transition plans, and access to climate finance.

Corporates and financial institutions will need to think about what changes to make now and in the future to address these efforts, which manifest in the four key ways considered below.

Setting global reporting standards

The influential International Financial Reporting Standards (IFRS) Foundation announced the establishment of the long-awaited International Sustainability Standards Board (ISSB), which will develop a global baseline of high-quality sustainability disclosure standards aimed at providing investors with the "consistent, complete, comparable and verifiable information" needed to assess how companies are addressing sustainability issues.

The IFRS' Technical Readiness Working Group (TRWG) published a prototype climate standard and a prototype general disclosure standard, which will lead to an enhanced set of recommendations that the ISSB will consider once the board's chair and vice-chairs have been appointed.

The prototypes consolidate key aspects of leading voluntary reporting standards and are built on the already widely-adopted Taskforce on Climate-related Financial Disclosures (TCFD) framework, draw on sector-specific standards including the SASB standards, and benefit from input from the World Economic Forum and the International Organization of Securities Commissions.

Like TCFD, the prototype climate standard requires disclosures relating to governance, strategy, risk management and metrics & targets. However, it does not include scenario analysis, which the UK recently announced will be required of large companies and LLPs.

The ISSB's standards need to be incorporated into domestic regulatory regimes to be mandatory. Their TCFD-related heritage is likely to make such adoption easier. The fact that the IFRS Foundation is looking to ensure compatibility with the EU's Corporate Sustainability Reporting Directive and initiatives in the Americas and Asia-Oceania will also help.

For businesses operating internationally, the fact that any international agreement needs to be integrated into domestic regimes adds delay, complexity and uncertainty around timing and what will be required. But the direction of travel is clear and businesses will want to start preparing sooner rather than later.

To date, climate disclosures have been mostly voluntary. If widely adopted, the ISSB's standard will mark a clear shift towards a more widespread and consistent baseline that streamlines and formalises sustainability disclosures. This would help reduce the risk and cost of having to make multiple-but-different disclosures in different jurisdictions.

The launch of the ISSB also heralds the planned consolidation of the Value Reporting

Foundation and Climate Disclosure Standards Board into the IFRS by June 2022. This should help mop up some - but not all - of the 'alphabet soup' of ESG standards which complicate the issue of addressing climate change, add cost and risk inadvertent greenwashing.

Businesses and financial institutions should look to the detail of the prototypes to gain insight into what is coming, and start to prepare now to make sure they can meet the standards, as the IFRS has said that they "will move diligently but with pace".

It is anticipated that further standards and guidance will need to be developed to build on the steps the ISSB is taking. It is also yet to be determined what exact role auditors will have in reviewing disclosures.

Spreading mandatory TCFD reporting

In the last year, the G7 nations, China and New Zealand amongst others have announced TCFD-aligned disclosures will be made mandatory. Shortly before COP, the UK government provided more detail on the next stage of its plans, publishing its Response: Mandatory climate-related disclosures by publicly quoted companies, large private companies and LLPs.

From April 2022, publicly quoted companies, large private companies and LLPs in the UK will join premium listed companies and large pension funds in being required to disclose climate-related financial information in line with TCFD's four overarching pillars: governance, strategy, risk management, metrics & targets.

Importantly, those in-scope will also be required to provide "an analysis of the resilience of the company's business model and strategy, taking into consideration different climate-related scenarios", also known as scenario analysis.

This goes beyond the Government's original proposal and the prototype ISSB standard. The Government recognises that this exercise can be daunting although it is not yet clear whether additional guidance will be provided beyond what TCFD have already produced.

Including scenario analysis marks a significant step up that will require businesses to reflect on how the impacts of climate change are taken into account and disclosed now as well as in the future.

Looking forward, whilst TCFD broadly requires disclosure of the impacts of climate change *on businesses*, the UK's proposed Sustainability Disclosure Requirements (SDR) will require businesses also to report their impact *on the climate*. This means that, likely from 2023/24, listed companies and subsequently the investment sector will need to develop systems to look both inward and outward when assessing climate impacts, sometimes referred to as "double materiality".

UK to require net zero transition plans

As part of its efforts to become the world's first "net zero financial centre" over the next few years, the UK announced at COP that:

- listed companies, asset managers and asset owners will initially be asked to publish transition plans taking account of the need to reach net zero or explain why they do not (as presaged by the UK's Greening Finance roadmap, discussed here);
- publication of transition plans will likely become mandatory under the SDR regime once it is in force;
- a Transition Plan Taskforce will produce a gold standard for transition plans, based on the science, to help address greenwashing concerns; and
- firm-level net zero commitments will not be mandatory, but left to businesses to decide.

The proposed legislation will help the statute book catch up with what privately-driven initiatives and shareholders are already requiring of some companies. Businesses should start thinking now about what their transition plans would look like and be conscious that even if they will initially be able to adopt a "comply-or-explain" approach, market practice, as well as wider shareholder and stakeholder pressures and expecations, may drive them to go further, sooner.

What remains to be seen is whether the rest of the world will follow the UK's lead, as for example the EU and US continue to develop their approaches to climate and sustainability.

Accessing finance

COP26 saw the Glasgow Financial Alliance for Net Zero (GFANZ) declare that firms representing 40% of the world's financial assets - US$130 trillion of private capital – are now committed to accelerating and mainstreaming the decarbonisation of the world economy. Developed nations have also (re)committed to providing US$100 billion per annum to developing nations.

As a result, funding will increasingly flow towards lower emission investments and assets, and the costs of capital for high-carbon assets could rise. Businesses will want to consider how best to make themselves eligible to benefit from this.

Unintended consequences

The increase in climate-related requirements focussed on public companies may impact capital allocation and further encourage the process already being seen of high-carbon assets being sold off to private companies that are subject to fewer disclosure or other requirements.

Rather than fundamentally changing the market, this process could shift rather than resolve the overall impact of businesses on climate issues, and highlights the danger of a piecemeal approach to climate requirements.

However, private businesses will still need to obtain finance and work with other businesses that will be within scope of relevant voluntary and legislative initiatives. They could therefore still find themselves held to account on climate issues even if not directly within scope.

Navigating the path post-COP

Taken together, the above paints a picture of a global financial and business landscape that will become increasingly challenging for activities unaligned with net zero. Financial institutions will be pressed to become greener as well as offering green finance, and those that use it will need to consider how they will transition to net zero and account for the sustainability impacts they have in an increasingly standardised and mandatory way.

This shift in requirements offers some hope of greater convergence on climate across the globe. However, that process is not complete and remains a moving target in any event, as requirements will need to be raised over time in order to achieve net zero.

As a result, there are still myriad complexities and pressure points that businesses will need navigate following COP26 that will continue to evolve over time.

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