ShareAction»

Combatting Greenwashing: TCFD Reporting

The role of mandatory climate-related disclosures in accelerating Paris-alignment

This briefing outlines ShareAction's views on forthcoming climate disclosure rules, due to come into force in the UK from October 2021. These reporting standards are a crucial tool in aligning UK businesses and investment portfolios with the UK's climate targets. Whilst climate-related disclosures are not a silver bullet, they represent the first step to more comprehensive data. In turn, this supports better understanding of what actions need to be taken to ensure the economy is on a path to net-zero. This briefing shines an independent spotlight on the UK Government's current plans for mandatory TCFD reporting and what policymakers can do to ensure that the regulations are robust and lead to genuine progress towards a climate-safe world.

This briefing outlines the following:

- Current plans for mandatory TCFD reporting;
- How these plans can be improved to ensure genuine Paris-alignment; and
- What policymakers can do to accelerate meaningful change in this area.

What is TCFD reporting set to look like?

Over the last few months, BEIS, DWP and the FCA have all published consultations on **mandatory climate-related financial disclosure** (or 'TCFD reporting') requirements for UK companies and pension funds, proposing the details of forthcoming regulations. Each government department is due to introduce its own framework, which is **expected to come into force from October 2021**.

Under the FCA's proposed guidelines, companies would have to disclose climate-related risks and opportunities that impact their business from a financial perspective, addressing the following:

1. **Governance** (the organisation's governance around climate-related risks and opportunities);

2. **Strategy** (the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning. The resilience of a company's strategy would be measured by its different climate-related scenarios, including a 2°C or lower scenario);

3. **Risk Management** (processes used by the organisation to identify, assess, and manage climate-related risks);

4. **Metrics and Targets** (metrics and targets used to assess and manage relevant climate-related risks and opportunities).

ShareAction welcomes progress made by BEIS, the FCA and DWP towards mandating TCFD reporting (particularly the latter, which has already made TCFD reporting mandatory for a significant number of UK pension schemes). However, **we believe proposals can go further**. The UK Government has already acknowledged this, noting in their Roadmap towards mandatory climate disclosures[1] that 'it may be necessary, in due course, to consider setting more detailed expectations for disclosures to supplement the TCFD recommendations and enhance comparability across UK organisations.'

Ensuring alignment with 1.5°C

The issue: Proposed TCFD regulation would require measurement of risks under different climate-related scenarios, including a '2°C or lower scenario'. This requirement is currently too vague and opens the door to pathways which overshoot 2°C and thus aren't credible for a climate-secure world.

The details: Proposed guidelines currently do not highlight the difference between exploratory and normative scenarios and are not explicit about what a 'preferred future' looks like. 'Paris-alignment' has been interpreted in different ways (e.g., from 1.5°C above pre-industrial levels to up to 2-3°C above pre-industrial levels), which has significant consequences on companies' transition plans and targets. New TCFD rules should encourage market participants to use normative climate scenarios compatible with a reliable 1.5°C pathway (defined as a 1.5°C outcome with no or limited overshoot). We were pleased to see BEIS announce in their consultation response report[2] that due to strong stakeholder support, they would introduce a qualitative scenario analysis requirement for TCFD reporting.

1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf
2 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1029354/tcfd-consultation-government-response.pdf

Furthermore, companies and financial institutions should be required to disclose the underlying scenario's assumptions (including temperature outcome; probability; and reliance on offsets, carbon capture storage or negative emission technologies) so that stakeholders can assess the credibility of their approach. Simply stating that a scenario is or is not 'Paris aligned' or 'net-zero aligned' is not sufficient for users to make a judgement on the company's target. Companies and financial institutions must also make (and disclose) realistic assumptions regarding technologies not yet available at scale or presenting important social and environmental risks (e.g., CCS and negative emission technologies) as per the IPCC's report on 1.5°C.

Our recommendation is that companies and financial institutions should be required to use a climate scenario aligned with a credible 1.5°C pathway and disclose any underlying assumptions. TCFD-aligned reporting should be more precise in relation to scenario analysis, and explicitly state that companies should strive for no hotter than a 1.5°C world, in line with the latest evidence from the IPPC. We also suggest requiring funds to include a sectoral breakdown in their reporting of emissions.

Scope 3 emissions should be included

The issue: The proposed TCFD regulation does not mandate reporting on value-chain or Scope 3 emissions, only Scope 1 and 2.

The detail: Scope 1 emissions cover Greenhouse Gas (GHG) emissions that a company emits directly, for example whilst running its boilers and vehicles. Scope 2 refers to indirect emissions, such as the electricity or fuel that is being produced on its behalf. Scope 3 emissions are those which are not owned or controlled by the company itself, but that the organisation indirectly impacts up and down its value chain. For example, emissions associated with products bought suppliers, or from its products when customers use them.

Proposing that firms should report only Scope 1 and 2 emissions, with no reporting on Scope 3 emissions until 2024 (as per the FCA) or at all (as per BEIS, who initially proposed continuing voluntary Scope 3 reporting, and have since announced they will 'consider' including it on a mandatory basis 'in due course'), is unacceptable. Scope 3 is often the greatest share of an organisation's carbon footprint by a significant margin – many organisations report that 80% of their emissions fall under Scope 3 and, for some, Scope 3 accounts for as much as 97% of their overall emissions[3].

3 https://www.edie.net/downloads/edie-Explains--Scope-3-carbon-emissions/492

Our recommendation is that the FCA require mandatory Scope 3 emissions reporting from the outset and allow the use of proxies and estimates while certain information is not yet available.

We propose that policymakers submit a parliamentary question to BEIS and DWP acknowledging that Scope 3 emissions can account for up to 97% of company' emissions, requesting that Scope 3 emissions are therefore included in mandatory reporting legislation.

The definition of 'risk' should be expanded

The issue: The proposed TCFD regulation only assesses *financial* risks and opportunities.

The details: Whilst assessing the financial risks and opportunities climate change poses to companies is a valuable first step, it's by no means the only factor that investors need to be aware of. For example, also pertinent is how a changing environment, such as more erratic weather patterns, might affect employees or consumers. Investors should assess not only the likely consequences of ESG factors on the financial value of their portfolios, but also what impact their portfolio and investment decisions have on society and the environment, taking what is known as a 'double materiality' approach. Without making this change, the investment system will continue to operate as if in a vacuum, as if its functioning has no impact on the real economy. And in doing so, it puts other systems important to our survival at risk.

The Treasury's Green Finance Roadmap[4], announced in October 2021, embeds the concept of double materiality via its proposed Sustainable Disclosure Requirements (SDR). This regulation will enable investors and businesses to have the information they need to understand "the full range of environmental risks they face and create". In other words, companies will be encouraged to report not just on how climate risks affect their business (outside-in), but also how their processes affect people and the environment (inside-out). Deploying this double materiality concept will help avoid regulatory uncertainty and further damage to our planet and its people, in turn making it easier for investors to determine which companies truly align with the aims of the Paris Agreement and the UN's Sustainable Development Goals.

Whilst plans for SDR are promising, the time frame to implement them – approximately 3-5 years – is still a long way away. With TCFD reporting due to come into force within 1-2 years, this presents an ideal opportunity for the UK Government to embed double materiality sooner. Not only will this make TCFD reporting more robust by reducing the risk of greenwashing, but it will

4 https://www.gov.uk/government/publications/greening-finance-a-roadmap-to-sustainable-investing

also allow the Government to direct its attention towards developing the Green Taxonomy, and other proposals unique to future SDR regulation, which go beyond the remit of TCFD.

Our recommendation is that TCFD-aligned reporting standards are broadened to include the concept of 'double materiality', as per proposals in the Green Finance Roadmap, and that this disclosure is introduced without delay on a mandatory basis.

We propose that policymakers urge Government to reduce proposed timeframes for the implementation of TCFD / SDR, to reflect the true urgency of the climate crisis and to honour the UK's Nationally Determined Contribution.

A need for proper enforcement

The issue: Whilst compliance with the proposed TCFD regulation would be mandatory, it is unclear how this will be enforced.

The detail: No government department proposal outlined how exactly these disclosures would be monitored, or how they would ensure the quality or comparability of data between companies. Without enforcement structures in place, it would be easy for companies and financial institutions to produce low-quality reporting or even greenwash their ambitions. InfluenceMap, a London-based NGO, found that more than half of climate-themed funds are failing to live up to the goals of the Paris Agreement[5]. If appropriate enforcement action is not taken where reporting is sub-standard or ESG claims are exaggerated, efforts to make reporting more sophisticated risk being undermined.

When it comes to white collar crime, the FCA exercises its enforcement powers, which include imposing a penalty on a firm or person; making public statements; and undertaking investigations and disciplinary actions. Whilst the FCA published an open letter[6] to authorised ESG & Sustainable Investment Funds encouraging them to improve the quality and clarity of their sustainability reporting in July 2021, we believe the authority can and should go further. The FCA should deploy its regulatory muscle to review and assess climate-related reporting, taking appropriate enforcement action where reporting is sub-standard.

5 Quinson, T. (2021), 'Regulatory Scrutiny of ESG Greenwashing Is Intensifying', Bloomberg. Retrieved from: https://www.bloomberg.com/news/articles/2021-09-01/regulatory-scrutiny-of-esg-greenwashing-is-intensifying

6 https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf

Our recommendation is that failure to comply with mandatory TCFD-aligned reporting should carry material consequences to ensure the whole of the UK economy, even laggards, make efforts to align with 1.5C.

We propose that the FCA develops a robust reporting assessment and enforcement mechanism, and that BEIS and DWP grant the FRC the powers to fine companies for failing to comply with best practice.

Contact

Isabella Salkeld,
UK Policy Officer, ShareAction
isabella.salkeld@shareaction.org

To learn more about ShareAction's work and our stance on a range of regulatory issues visit our website.

63/66 Hatton Garden
Fifth Floor, Suite 23
London UK
EC1N 8LE

info@shareaction.org
+44 (0)20 7403 7800

UK registered charity number: 1117244

EU Transparency Register number: 75791956264-20

Belgian organisation number: Fairshare Educational Foundation 0672.921.563

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ShareAction is a registered charity working globally to define the highest standards for responsible investment and to drive change until these standards are adopted worldwide. Our vision is a world where the financial system serves our planet and its people.