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ESG Analysis

# TalkingPoints

## Better Disclosure of ESG Risks and Opportunities Will Unlock Capital for Sustainable Development and Green Finance


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Data is the key to scaling sustainable finance. Uncovering it is the challenge. EU policymakers should be bold in implementing the recommendations of the Task Force on Climate-related Financial Disclosure (TCFD) as this will drive the availability of relevant, comparable, and consistent data for investment decisions. Without meaningful disclosure data, markets will remain blind to the financial implications of climate risks. Without this data, market participants may fail to identify this century's major growth opportunities.

### What are the barriers to sustainable finance?

The EU High-Level Expert Group (HLEG) on Sustainable Finance's interim report has outlined the systemic change needed to make financial markets more sustainable. As a member of HLEG, let me list the main problems we have encountered.

**Asset owners** have locked up significant capital in unsustainable, carbon-intensive investments. They are seeking investments that deliver long-term enhanced returns, while at the same time helping to fund the transition toward a greener and more sustainable economy. There is limited information available today on how assets are performing on ESG issues and the link to financial return over the longer term. This is impeding capital allocation to sustainable investments.

**Asset managers** are usually only provided with a relatively short-term mandate by the majority of institutional asset owners and are monitored on a quarterly basis with limited or no requirement to report on the ESG performance of their portfolios. This drives short-term and often unsustainable behavior.

**Companies** across many sectors may need to invest significantly in order to avoid material ESG risks and take advantage of the transition to a more sustainable economy. Issuers, however, complain that there is not enough capital available for the projects they need to invest in to drive the shift to a more sustainable business model at scale. This is often due to a lack of clarity about the financial and ESG benefits of these projects over both the short and long term.

**Governments** have made ambitious commitments, such as the Paris Agreement on climate change and the Sustainable Development Goals, but they lack the capital required to achieve their goals. Capital markets will have to help fund the transition required if these international and national commitments are to be met.

**Development banks** can initially drive uptake of green or sustainable projects, but they often lack private sector partners to match their contributions and continue to fund these projects to scale.

The common problem that underpins the systemic challenge is a general lack of disclosure and analysis on the financial opportunities and risks, both short and long term, associated with ESG. Sustainable development requires significant capital, but this can only be provided if there is enough information flowing along the investment chain. Markets can only be efficient if there is a timely and relevant flow of information. Trucost has analyzed the disclosure of 6,300 firms in its Environmental Register database and only 46% provide standardized quantitative information on carbon emissions, only 36% on air emissions, and only 21% on water dependency. Data is often insufficiently robust, financially relevant, or forward-looking, meaning that market participants cannot incorporate this information into the investment process.

## What solutions are market participants calling for?

The market is calling for much greater standardization of disclosure to require companies and market participants to publish the data needed to inform decision making. The EU should strengthen corporate disclosure requirements, proactively monitor compliance, and ensure that organizations that do not meet the new disclosure standards are held to account. The TCFD implementation guidance for financial and non-financial sectors provides an excellent starting point on what these new data disclosure requirements should look like. The HLEG interim report supports this by recommending that "the recent TCFD recommendations should be integrated in a way that advances EU leadership… providing legal certainty and maintaining a level playing field globally." The review of the EU Non-Financial Reporting Directive presents a timely opportunity to achieve this.

## What could this mean in practice?

There are several elements of the TCFD recommendations that can be implemented in Europe, and I will outline two examples.

As a first step, the EU can encourage or mandate companies to conduct scenario analysis to assess the resilience of an organization's strategy to climate risks, taking into consideration a 2°C scenario. The tools to do this exist already. For example, Trucost has just launched a carbon pricing tool to help companies, market participants, and banks conduct scenario analysis. This tool quantifies the impact of carbon pricing and taxation on operating margins for companies at the entity and asset level. This type of assessment is critical, as it will allow decision makers to define financially material risk over various timeframes and highlight opportunities to create more resilient business models. As the TCFD points out, the disclosure of the results of scenario analysis will allow market participants to assess:

- The degree of robustness of the organization's strategy and financial plans under different plausible future states of the world;
- How the organization may be positioning itself to take advantage of opportunities and plans to mitigate or adapt to climate-related risks; and
- How the organization is challenging itself to think strategically about longer-term, climate-related risks and opportunities.

The disclosure of company-level climate risks and opportunities will allow investment managers to make better decisions. However, it will be important for asset owners to understand how each portfolio, across different asset classes, is performing overall as this will guide capital allocation. It is therefore critical that asset managers also report on metrics used to assess climate-related risks and opportunities in each fund or investment strategy.

As a second step, the EU could make it mandatory for asset managers to disclose the weighted average carbon intensity for each fund and strategy, and consider other useful carbon exposure metrics, such as how aligned the portfolio is with a 2°C scenario. Again, the tools to do this are already in use. Trucost has recently identified five key approaches to assess the climate risks associated with portfolios and has applied this to several major benchmarks—see the S&P Dow Jones Indices Carbon Scorecard.

These two examples highlight how the TCFD recommendations can be specifically applied in a European policy context. Note that these approaches do not need to be focused just on carbon risks, but they can also address other environmental impacts, such as water, along with ESG issues and SDG alignment. Although most listed companies do not disclose water-related financial risks, Trucost estimates the total unpriced water risk at USD 439 billion factoring water scarcity and water quality issues. Social metrics must also be disclosed if the EU's goals of creating good quality jobs, tackling inequality, and delivering inclusive growth are to be achieved.

## What are the benefits?

Better disclosure of ESG risks, alongside other much needed reforms, such as a clearer definition of the relation of ESG to fiduciary duty, will allow market participants to more accurately price risks and allocate capital toward sustainable development. The EU can lead on sustainable finance and now is the time for EU policy makers to be bold by advancing and integrating the TCFD recommendations for corporate disclosure into our capital markets.