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> "A 'one rule fits all' approach has its limitations, but standardisation of ESG reporting and disclosure requirements would help banks as they gather data to complete climate change stress testing".
>
> Janine Dow, Fitch Ratings

Standard Data Would Help Stress Testing

Developed-market banks already face climate change stress tests in a number of countries. They need to gather standardised data on how physical and transition environmental factors translate into financial risks across their entire business chain, including their corporate clients' exposure to climate-related risks.

However, banks and their corporate clients adhere to varying voluntary disclosure standards, and not all corporates are ready to provide inputs to meet banks' needs.

Banks would be more advanced in their climate and environmental, social and governance (ESG) data collection processes if a common sustainability standard were in place, ideally under the guise of a single authority or industry body. This, in turn, could go some way to ensuring that the stress tests use reliable, high quality and comparable data, potentially leading to better stress test results.

Harmonisation and Compulsion

September 2020 saw some breakthrough developments that could eventually lead to harmonised sustainability and financial reporting standards.

Five leading voluntary standard-setters announced they are working together to develop a single ESG reporting system.

The IFRS Foundation also published a consultation paper to assess the level of demand for global sustainability standards and to determine whether it should play a role in the development of these.

With a view to common mandatory corporate disclosures, the EU is proposing draft legislation by end-2020 to amend a key directive the Non-Financial Reporting Directive (NFRD). This will force large EU companies to provide more detailed and standardised public sustainability information from 2021.

And in October 2020, the Bank of England called for all corporates to 'measure, model and disclose' their climate risks and for standard setters to agree on a single framework to make disclosures consistent, decision useful and forward looking.

Widespread Benefits

The standardisation of ESG reporting and disclosure would make it easier for market participants to compare and assess how ESG risks impact the creditworthiness of banks. This is important because investors and analysts benchmark against peers as they conduct their research. Like-for-like data is more straightforward.

Transparency A Key Input

ESG reporting is, in our view, complementary to financial reporting. Transparency is a key input in Fitch Ratings' assessment of an issuer's governance and an important consideration in the ESG Relevance Scores we assign to issuers. Improvements in ESG reporting standards will bring additional clarity to our assessments.

Related Research

Bank Climate-Change Stress Tests (September 2020)

Financial Sector Confronts Deforestation as Key ESG Risk (September 2020)

US, EU ESG Investment Management Rules Diverge (September 2020)

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Market Finds Current Disclosures Confusing

Market participants who rely on public information to help inform their investment and economic decisions find the current lack of disclosure standardisation confusing. The IFRS Foundation says they are aware of 'more than 650 different metrics available for companies looking to undertake sustainability reporting, not to mention initiatives from multiple governments and international organisations promoting just climate change'.

In common with other corporates, banks provide information about their ESG risks and opportunities in a non-standardised manner. In addition, publicly disclosed information is often spread across a number of separate documents. For example, a bank might include a description of its ESG risk management framework in the risk section of its annual report, details of its lending and investment limits to sectors considered harmful to the environment might be included in a separate sustainability report, and data on its employee and diversity policies are often found in a separate set of CSR documents.

The reporting of indirect ESG risks and opportunist faced by banks arising from exposure to their underlying customers is particularly patchy.

The absence of standardised sustainability reporting measures makes comparison across companies and geographies difficult and the spread of data across various documents makes it inefficient to source the data. The adherence to multiple reporting requirements is costly to reporting companies.

TCFD Leads on Climate-Change Reporting

Company reporting guidelines for climate-change are fairly well advanced relative to other environmental risks. Although there are numerous initiatives focusing primarily on climate-change risk reporting, the guidelines from the Task Force on Climate-Related Financial Disclosures (TCFD) are rapidly becoming the international norm. Several countries (Japan, Taiwan, New Zealand) have already made reporting in line with these guidelines a regulatory requirement, and most banks which are founding members of the TCFD align their climate risk disclosure with its recommendations.

Task Force on Climate-Related Financial Disclosures

Established by the Financial Stability Board, the TCFD comprises a group of members drawn from international financial, non-financial and expert organisations tasked with developing a set of voluntary recommendations relating to disclosure on climate-change.

The TCFD recommendations, published in 2017, focus on climate-related disclosures around governance, strategy, risk management (in particular climate-change scenario analysis), and related metrics and targets. TCFD recommendations have received widespread international support from reporters.

Climate Stress Tests Spur Harmonisation

As bank climate stress testing becomes more mainstream and market participants increasingly push for greater harmonisation across scenarios and economic variables employed in the tests, our view is that banks will begin to gather climate data in a more standardised manner, if only to simplify completion of the tests.

Ideally, a clear and consistent global taxonomy of climate-sensitive assets allied with similarly consistent transparency initiatives, plus market participant pressure, would lead to more consistent and comparable bank climate disclosures over the medium term.

However, Fitch recognises that standardisation can happen at multiple levels and a 'one rule fits all' approach might not always work, especially because different tools attempt to measure different risks.

Standardisation of individual data metrics makes sense as these can be fed into climate risk models and labelling of instruments – even where the ESG scores and ratings are set out to achieve a different objective. In addition, the products will likely use subjective definitions of what is meant by 'sustainability' (although within the EU, the Sustainable Finance Taxonomy will set guidelines).

On the flip side, it can be argued that the standardisation of data towards the lowest common denominator, or regulatory enforcement of simplistic modelling tools could prove detrimental to innovation and potentially to stakeholder needs. Nevertheless, we believe the overall drive towards common ESG reporting is beneficial for banks as clear guidance would simplify their reporting process.

Sustainability Disclosure and Financial Reporting

- Sustainability disclosure, also referred to as ESG or non-financial disclosure, refers to the publication of information regarding sustainability topics which are relevant to a company's business and have a significant impact on the economy, environment and on people.
- Some ESG impacts may already be reflected in financial reporting. For example, some banks are already setting aside provisions to reflect higher expected loss probabilities on certain assets, such as mortgage portfolios located in high flood risk areas. But the link between financial and non-financial reporting is generally unclear and this makes it difficult to assess how and if banks are allocating sufficient capital to absorb their expected ESG losses.

Standardisation Is Important for Banks

Our view is that market participants, including credit rating agencies, that are interested in assessing a company's performance would be better served if ESG business risks were integrated into financial reporting using a common set of internationally comparable metrics. It would also be useful if all ESG-related information were centralised in one document, and if all ESG risks, opportunities and sustainability objectives were reported under a globally standardised framework, using a set of harmonised fixed-field tales and or fixed-form metrics (where feasible).

This is true for all companies, but is particularly important for banks in our view. This is because regulators are more advanced in their efforts to ensure banks reflect the impact of ESG and sustainability issues on their financial and non-financial risks, and ultimately in their balance sheet capital and reserves. However, regulators conducting the current round of climate-change stress testing in France and the UK point out that banks have already warned of data gaps which could make it difficult for them to provide some of the model inputs required.

Had standardisation of climate-related reporting metrics already been in place, banks would likely have had a head start in collecting relevant data throughout their business chains and been better placed to respond to regulatory requests. It is possible that regulators, too, would have benefited from the ability to use standardised data as a starting point for their model feeds had this been available. Standardised data would likely boost efficiency.

It is likely that scrutiny will move beyond climate change towards a broader range of ESG risks. Clear direction regarding the pathway for new standards would be helpful for banks at a time when investors and customers are increasingly turning their attention to their stance on environmental and social policies. This will, we believe, lead stakeholders to demand greater disclosure on banks' green and sustainable policies.

Ultimately, better, more harmonised, disclosure should help market participants form clearer opinions about which banks are making more determined efforts to contribute to overall sustainability goals and which are the most effective players in driving positive climate change. Consequently, ESG reporting laggards may find it more difficult to attract investment and access funding markets as investors become more discerning.

Aligning ESG Standards – A Dynamic Trend

There is no prescriptive global standard, as yet, for how companies should report on their sustainability risks. Voluntary standards vary in scope and objective and regulators are moving at different speeds. However, recent events suggest harmonisation efforts are speeding up.

In September 2020, the World Economic Forum's International Business Council (IBC), in conjunction with Deloitte, EY, KPMG and PWC, published a set of universal ESG financial, quantifiable, metrics which could be included in financial reporting published by issuers globally. There are 21 'core' and 34 'expanded' metrics and the essential principle is that issuers should report under as many metrics as possible and 'disclose or explain' when this is not possible.

Also in September, the five largest voluntary standard-setters[1] announced they are working together to establish a single ESG reporting system which is complementary to the efforts made by IBC. A table at the end of this report provides key comparative information about these standard-setters plus NFRD highlights. We believe this is good news given the profile of the names involved. The objective of the five standard setters is to create a coherent reporting set of standards detailing how sustainability reports should be produced using a common set of standards and disclosure requirements.

[1] CDP, The Climate Disclosure Standards Board, The Global Reporting Initiative, the International Integrated Reporting Council and the Sustainability Accounting Standards Board.

Building IFRS Sustainability Standards

On 30 September 2020 the IFRS Foundation (which oversees the work of the IASB) published a consultation paper to assess the level of demand for global sustainability standards and to determine whether it should play a role in the development of such standards. The consultation period closes at end-2020.

Since many banks report under IFRS (with the exception of smaller banks, that report under local GAAP), market participants are already familiar with these standards. Were a set of IFRS sustainability standards to be developed, they could be integrated into financial statements, providing readers with easy access to centralised financial and ESG information as well as details of how both areas are connected.

On the same day, the five sustainability standard-setters referred to earlier published an open letter to the Chair of the Sustainable Finance Task Force of the International Organization of Securities Commissions (IOSCO) calling for more action.

They emphasised the need to work together to meet the increased needs of the capital markets for access to standardised sustainability reporting - described as 'an architecture of connected reporting' - under the oversight of the IFRS Foundation. If this were to succeed, given their global scope, the IFRS could lead the way in driving harmonisation in ESG-reporting, and in the context of international financial reporting standards.

EU Non-Financial Disclosure Reporting Directive (NFRD)

Formally known as Directive 2014/95/EU, the NFRD provides non-binding guidelines for the non-financial statements in the annual reports of public-interest entities (PIEs) with more than 500 employees (and with either a balance sheet total of more than EUR20 million or a net turnover of more than EUR 40 million),

The non-financial statement should include information necessary for understanding the development, performance, position and impact of the entity's activities, as they relate to at least environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters. The content should include at least a description of (i) the entities' business models; (ii) related policies and due diligence process; (iii) policy outcomes; (iv) the main risks arising from the non-financial matters out of the entities' operations; and (v) non-financial key performance indicators.

If companies do not have a policy on any of these environmental or other non-financial areas it should be reporting on, the non-financial statement should explain why not. Companies also have to report on their policy regarding the diversity of the board of directors.

The regime came into force in December 2014 and had to be implemented into national law by December 2016. Since then, there have been a number of consultations to broaden and deepen its application.

EU NFRD Heralds Improved Disclosures

If the timetables go according to plan, draft legislation reflecting the outcomes of consultations to amend the EU's existing Non-Financial Disclosure Reporting Directive (NFRD) could be adopted by 4Q20. The changes to the NFRD could make it more aligned to other ESG focussed EU regulations, such as the Disclosure Regulation and Taxonomy Regulation. This could mean that large EU companies would be required to provide greater, more standardised, public sustainability information from the start of 2021.

This is good news as, once in place, investors should be better informed about companies' climate and environmental data and about the sustainability of their investments. And banks will have access to more standardised comparable information, to help fulfil their ESG and climate-change related disclosures.

The current system of voluntary, non-standardised, reporting in the EU is probably inadequate given the high level of investment required to finance the European Green Deal. The lack of ESG standardisation and disclosure may act as a barrier to investment and the slow achievement of Green Deal targets. The European Commission's review of the NFRD aims to address inadequacies. Weak spots identified include the insufficiency, usefulness and comparability of information provided by companies, as well as difficulties in locating the information even when it is made available.

Our view is that the EU is leading the way in sustainability reporting, as demonstrated by the push for the NFRD and related ESG and Taxonomy Regulation. Our expectations are that developments currently underway will lead to both greater enforcement of ESG reporting and its applicability to a broader category of companies. We also expect access to data to improve given there are several initiatives to create centralised databases for consultation.

EU Banking Authority Pillar III Changes

The European Banking Authority proposes that, from 2021, bank disclosures required under Pillar III should incorporate quantitative and qualitative ESG data. This will be used to foster a greater understanding of how banks' risk management systems assess assets associated with environmental and social objectives. We expect to see companies publishing more detailed, useful and standardised ESG data from 2021. We might also see a requirement for the inclusion of independent assurances regarding the data provided.

US Lags Behind Peers for Disclosure Needs

Sustainability disclosure requirements for US companies are still at an early stage. Despite announcements made early in 2020 that the SEC would be 'modernizing' its disclosure requirements for publicly traded firms (referred to as Regulation S-K), and considerable market lobbying for some inclusion of ESG issues, the final revision announced in September 2020 is silent on climate-change risk. Regulation S-K says that companies have to report on issues which are "reasonably likely to have a material effect" on the firm's financial condition or operating performance. To the extent that climate change is deemed to represent a material risk, this would have to be disclosed.

The only recent significant developments on ESG disclosure came in the form of a report published by the market risk advisory committee of the US Commodity Futures Trading Commission (CTFC) on 9 September 2020. This is not one of the leading risk advisory groups in the US, but the report is important because it marks a 'first' in terms of a regulatory authority (or a sub-committee of an authority) speaking up about the need for recognition of climate-change risk in financial markets.

The CTFC report is comprehensive and draws attention to climate-change risks and opportunities and makes several key recommendations addressed to the US authorities and policy-makers. It recommends that all financial regulators in the US should incorporate climate-change risk policies, commitments and timeframes into their frameworks. It also discusses how ESG disclosure could be improved. To date in the US, all such disclosure is voluntary and the report notes that "the quality of climate disclosure in the United States by issuers largely remains inadequate for the needs of investors".

However, at a state level, some areas, notably New York, are pushing ahead with demands for greater ESG disclosure and standardisation.

Japan Progresses with ESG Disclosures

Large Japanese companies, including banks, have reported on their environmental risks since the 1990s. CSR reporting has been common practice since the early 2000s and sustainability reporting gathered pace in 2015 when the country's government pension investment fund signed up to the PRI initiatives and stewardship and governance codes were introduced. Disclosure guidelines meeting TCFD recommendations are widely used but much disclosure is still on a voluntary basis. Many large companies adopt an integrated reporting approach which can result in lengthy documents which at times lack transparent linkage between financial and non-financial considerations.

Chinese ESG Disclosure Grows

From 2020, large Chinese companies, including those that are state-owned, have to comply with disclosure of ESG risks associated with their operations. ESG reporting requirements and disclosure guidelines tend to be fairly prescriptive in China, laid down by mandates from a range of official bodies, including the Securities Regulatory Commission and the Ministry of Environmental Protection.

The Shanghai and Shenzhen stock exchanges also encourage all issuers to increase ESG disclosures, but the option is voluntary. The effort is consistent with President Xi Jinping's call for the development of "green finance", including the mandatory release of environmental data, in a bid to draw more foreign investment into the country. The Chinese Securities Regulation Committee's ESG disclosures, mandatory for over 3,000 Chinese companies, was set to come into effect in 2020 but the guidelines have not yet been published. Our view is that the topic will be discussed in the agenda for the forthcoming five-year plan. So enhanced ESG disclosures represents an opportunity for Chinese firms.

Fitch-rated Chinese banks, however, are often scored '4' for financial transparency under our ESG Relevance Scores to reflect the under-reporting of non-performing loans and risk-weighted assets stemming from the use of off-balance-sheet transactions. This negatively affects several banks' credit profile and is relevant to the rating in conjunction with other factors.

Selected Standards & Reporting Frameworks - Key Comparative Highlights

Framework	Sustainability Accounting Standards	Global Reporting Initiative	CDP	Climate Disclosure Standards	International Integrated Reporting	Taskforce for Climate-Related Financial Disclosure (TCFD)	Non-Financial Reporting Directive (NFRD)
Type	Voluntary	Voluntary	Voluntary, but often driven by disclosure requests from investors or downstream customers	Voluntary	Voluntary	Voluntary for most[a]. Mandatory for financial institutions in Japan, New Zealand & Taiwan	EU regulation, non-binding
Alignment with TCFD	Well aligned with metrics and targets disclosures	Some TCFD recommendations not fully covered	Nearly full alignment	Nearly full alignment	Good alignment with many TCFD recommendations	n.a.	n.a.
Applicability	Financial and non-financial companies	Non-financial companies	Non-financial companies	Financial and non-financial companies	Financial and non-financial companies	Financial and non-financial companies which have issued debt or equity in public markets; asset managers and asset owners, including pension plans, endowments and foundations	Public interest companies with more than 500 employees plus companies designated by national authorities
Intended users	Investors and creditors	Stakeholders including society	Stakeholders, including investors, purchasing entities (supply chain) and policymakers	Investors and creditors	Investors and creditors	Investors, creditors, central banks and financial regulators	Broad range of stakeholders, including financial sector
Approach	Industry-specific sustainability standards covering environmental and social factors	Three universal standards and 33 topic-specific standards or impacts on economy, environment and society. Specific standards for Oil & Gas, Coal and Agriculture are being developed	Topic-specific (climate change, water security, forests) with greater industry specificity for high impact sectors	Standards for environmental, natural capital and climate change disclosure & reporting; recommend disclosure in mainstream reporting	Seeks to integrate sustainability performance and traditional financial metrics in one annual report with unified financial and non-financial narrative	Governance framework with emphasis on climate-related disclosure; provides general and sector-specific guidance	Principles-based disclosure on environmental protection, social responsibility and employee treatment, respect for human rights, anti-corruption and diversity
Approach to materiality	Reporting company's most probable financial materiality mapped by industry sector and sub-sectors	Materiality relates to the significant impact which the reporting company has on the economy, the environment or society and information which can substantively influence assessments and decisions of the company's stakeholders	Information requested by investors and downstream customers is considered relevant and material	Climate-related issues are material; uses IASB definition of financial materiality	Matters that substantively affect the company's ability to create value over the short, medium and long term are considered financially material	Climate-related issues considered systemically important. The reporting company decides what is financially material	Dual E, S or G materiality; e.g.: the impact of climate change on the reporting company and the reporting company's impact on the environment and society

Selected Standards & Reporting Frameworks - Key Comparative Highlights (Cont.)

Framework/ body	Sustainability Accounting Standards/SAS board	Global Reporting Initiative/GRI	CDP	Climate Disclosure Standards/CDS board	International Integrated Reporting/IIR council	Taskforce for Climate-Related Financial Disclosure (TCFD)/financial stability board	Non-Financial Reporting Directive (NFRD)
Structure of ESG disclosure	Financial accounts style tables of sustainability metrics	General disclosure including business strategy and policies, management approach	Climate change questionnaire covering governance, risks and opportunities, business strategy, targets & performance, emissions data, verification methodology and, for water security and forests, topic-relevant data	Disclosure on governance, policies, risks & opportunities, sources of environmental impact, performance, comparative analysis, outlook	Financial and non-financial disclosure on all ESG topics	Disclosure on governance, strategy, risk management, targets & metrics	Disclosure on business model, policies and due diligence, outcome policies, principal risks and KPIs
ESG specifics	Disclose only when expected to be financially material	Disclose when expected to be material to stakeholders, including society	Disclosure on climate change focused on high GHG emitters. Widening scope to cover more companies and expanding into disclosure on water security and forest protection	Climate-related disclosure recommended for all companies but reporting entity determines financial materiality	ESG disclosure should be integral part of reporting	Climate-related disclosure recommended for all companies but reporting entity determines financial material	Disclosure required where material to stakeholders, including regulators & society
GHG Emissions	Scope 1 only for sensitive sectors	Reporting entity decides, but standard includes Scope 1, 2 & 3	Scope 1,2 & 3, sector-specific especially for high-emission sectors	Scope 1 & 2	Not specified	Scope 1 & 2 and 3 if applicable	Reporting entity decides, but standard includes Scope 1, 2 & 3

[a] The UK's Department for Work & Pensions is consulting on requiring UK pension schemes to publicly disclose climate risks by 2022 using TCFD. The UK's Green Finance Strategy makes it clear that all listed companies and large asset owners will likely need to make disclosures using TCFD by 2022

Source: Fitch Ratings; Corporate Reporting Dialogue 2019

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