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CFTC's Climate Risk Report and Other Developments on ESG Disclosure for Corporate Issuers

[32764]

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ICI Global Members
ESG Task Force (Global)
ESG Working Group (US) SUBJECTS: Disclosure
ESG
Financial Stability
International/Global
Investment Advisers
Pension
Valuation RE: CFTC's Climate Risk Report and Other Developments on ESG Disclosure for Corporate Issuers

This memorandum briefly summarizes two recent developments with potential implications for funds that use ESG integration or other sustainable investing strategies:

- The Commodity Futures Trading Commission's (CFTC) Climate-Related Market Risk Subcommittee published a report on *Managing Climate Risk in the US Financial System*[1];and
- Five global ESG standard-setting organizations jointly published a *Statement of Intent to Work Together Towards Comprehensive Corporate Reporting*.[2] These organizations are the Sustainable Accounting Standards Board (SASB), Global Reporting Initiative (GRI), International Integrated Reporting Council (IIRC), CDP (formerly the Carbon Disclosure Project), and Climate Disclosure Standards Board (CDSB).

1. CFTC's Climate Risk Report

Background. CFTC Commissioner Behnam initiated the CFTC's effort to examine climate-related impacts on the financial system with the formation of the Market Risk Advisory Committee's Climate-Related Market Risk Subcommittee in 2019.[3] The Subcommittee recently released its report on *Managing Climate Risk in the US Financial System* with 53 recommendations to mitigate the risks to financial markets posed by climate change.[4]

The report concludes that:

- Climate change poses a major risk to the stability of the US financial system and to its ability to sustain the American economy;
- Climate risks may also exacerbate financial system vulnerabilities that have little to do with climate change, including vulnerabilities caused by a pandemic that has stressed balance sheets, strained government budgets, and depleted household wealth;
- US financial regulators must recognize that climate change poses serious emerging risks to the US financial system, and they should move urgently and decisively to measure, understand, and address these risks;
- Existing statutes already provide US financial regulators with wide-ranging and flexible authorities that could be used to start addressing financial climate-related risk;
- Regulators can help promote the role of financial markets as providers of solutions to climate-related risks; and
- Financial innovation is required not only to efficiently manage climate risk but also to facilitate the flow of capital to help accelerate the net-zero transition and increase economic opportunity.

Climate-related corporate issuer disclosure. The report states that corporations disclosing information on material, climate-related financial risks is an essential building block to ensure that climate risks are measured and managed effectively. The report explains that climate-related financial disclosure benefits several parties as follows:

- Disclosure enables financial regulators and market participants to better understand climate change impacts on financial markets and institutions.
- Issuers can communicate risk and opportunity information to capital providers, investors, derivatives customers and counterparties, markets, and regulators and learn from peers about climate-related strategy and best practices in risk management.
- Investors can assess risks to firms, margins, cash flows, and valuations, allowing markets to price risk more accurately and facilitating the risk-informed allocation of capital.

The report goes on to note that the existing disclosure regime has not resulted in disclosures of a scope, breadth, and quality to be sufficiently useful to financial regulators or market participants. The report asserts that the following barriers are holding back capital from flowing to sustainable, low-carbon activities:

- There is a misperception among mainstream investors that sustainable or ESG investments necessarily involve trading off financial returns relative to traditional investment strategies.
- The market for products widely considered to be “green” or “sustainable” remains small relative to the needs of institutional investors.
- There is a lack of trust in the market over concerns of potential “greenwashing” (misleading claims about the extent to which a financial product or service is truly

climate-friendly or environmentally sustainable).

- Policy uncertainty is holding back the market, including in areas such as regulation affecting the financial products that US companies may offer their employees through their employer-provided retirement plans.[5]

Reference to mutual funds. The report notes that financial institutions, including mutual funds, often hold climate-related assets that may be affected by climate risk and that prudent management of climate risk is therefore essential. More specifically, the report states that:

> [m]ost of them hold assets that may be affected—and in some cases are already being affected—by transition or physical risk. Ineffective management of these risks could lead to large financial losses, which in turn could trigger asset fire sales and elevated counterparty risk. These events can channel financial contagion. Also, because climate risk is expected to increase over time, asset holders with longer asset-liability structures are more exposed to climate risk.[6]

Relevant recommendations. The report presents 53 recommendations to mitigate the risks to financial markets posed by climate change. We describe the most relevant ones below.

- Financial supervisors should require bank and nonbank financial firms to address climate-related financial risks through their existing risk management frameworks in a way that is appropriately governed by corporate management. That includes embedding climate risk monitoring and management into the firms' governance frameworks, including by means of clearly defined oversight responsibilities in the board of directors. (Recommendation 4.7, page 51)

- The CFTC should undertake a program of research aimed at understanding how climate-related risks are impacting and could impact markets and market participants under CFTC oversight, including central counterparties, futures commission merchants, and speculative traders and funds; the research program should also cover how the CFTC's capabilities and supervisory role may need to adapt to fulfill its mandate in light of climate change and identify relevant gaps in the CFTC's regulatory and supervisory framework. (Recommendation 4.11, pages 51-52)

- Financial regulators, in coordination with the private sector, should support the availability of consistent, comparable, and reliable climate risk data and analysis to advance the effective measurement and management of climate risk. (Recommendation 5.1, page 70)

- Financial regulators, in coordination with the private sector, should support the development of US-appropriate standardized and consistent classification systems or taxonomies for physical and transition risks, exposure, sensitivity, vulnerability, adaptation, and resilience, spanning asset classes and sectors, in order to define core terms supporting the comparison of climate risk data and associated financial products and services.[7] (Recommendation 5.2, page 70)

- Material climate risks must be disclosed under existing law, and climate risk disclosure should cover material risks for various time horizons. To address investor concerns around ambiguity on when climate change rises to the threshold of materiality, financial regulators should clarify the definition of materiality for disclosing medium- and long-term climate risks, including through quantitative and qualitative factors, as appropriate. (Recommendation 7.2, page 99)

- In light of global advancements in the past 10 years in understanding and disclosing climate risks, regulators should review and update the SEC's 2010 Guidance on climate risk disclosure[8] to achieve greater consistency in disclosure to help inform the market. Regulators should also consider rulemaking, where relevant, and ensure implementation of the Guidance.[9] (Recommendation 7.5, page 100)

- US financial regulators should review relevant requirements and provide any necessary clarity to confirm the appropriateness of making investment decisions using climate-related factors in ERISA retirement plans and non-ERISA investments managed by a fiduciary. This should clarify that climate-related factors—as well as ESG factors that impact risk-return more broadly—may be considered to the same extent as "traditional" financial factors, without creating additional burdens. (Recommendation 8.4, page 116)

- The CFTC should coordinate with other regulators to support the development of a robust ecosystem of climate-related risk management products. (Recommendation 8.5, page 117)

2. Five ESG Standard-Setting Organizations Announce Intent to Collaborate

Five global ESG standard-setting organizations jointly published a *Statement of Intent to Work Together Towards Comprehensive Corporate Reporting* (Joint Statement). These organizations—SASB, GRI, IIRC, CDP, and CDSB—set frameworks and standards for sustainability disclosure, including climate-related reporting, along with the recommendations from the Task Force on Climate-Related Financial Disclosures (TCFD).

According to the Joint Statement, these organizations have come together to help resolve confusion among users of sustainability-related corporate information and to show a commitment to working towards a comprehensive corporate reporting system. The Joint Statement indicates that they plan to progress towards more comprehensive corporate reporting on the basis of the following considerations:

- The conditions are ripe for the development of a market-based and globally coherent solution for sustainability disclosure standards. Specifically, climate change, the global pandemic, and the increasingly clear connection between sustainability performance and financial risk and return are driving the urgency for sustainability disclosure standards.

- Sustainability disclosure that is material for enterprise value creation should ideally be disclosed along with information that is already reflected in the annual financial accounts. This would connect sustainability disclosure standards that are focused on enterprise value creation to financial generally accepted accounting principles.

- It is important to establish a model for financial reporting, in which a private and independent standard-setting body develops standards, with public authority oversight, together with appropriate regulation and enforcement established by regional authorities.
- Formal collaboration is essential to ensure that disclosure requirements for a given topic are the same across the building blocks, unless there are legitimate reasons for differences.

- The role of Europe is crucial in achieving a global solution. Europe is in a prime position to mandate all “building blocks” of a comprehensive corporate reporting system, which would achieve the model of global standards supplemented by specific jurisdictional regulatory requirements.

- All stakeholders must be engaged to achieve the globally accepted comprehensive corporate reporting system that is urgently needed. This includes the International Organisation of Securities Commissions (IOSCO), the International Financial Reporting Standards (IFRS) Foundation, the World Economic Forum, and other interested stakeholders across the ecosystem, such as companies, investors, governments, and civil society.

The Joint Statement concludes with a commitment to providing joint market guidance on how the five frameworks and standards can be applied in a complementary and additive way; a joint vision of how these elements could complement Financial GAAP and serve as a starting point for progress towards a comprehensive corporate reporting system; and a joint commitment to work toward making the frameworks and standards interoperable.

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endnotes

[1] The report (September 9, 2020) is *available at* https://www.cftc.gov/About/AdvisoryCommittees/MarketRiskAdvisory/MRAC_Reports.html.

[2] The Statement (September 2020) is *available at* https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf.

[3] *See* Press Release, *CFTC Commissioner Behnam Announces Members of the Market Risk Advisory Committee’s New Climate-Related Market Risk Subcommittee* (Nov. 14, 2019), *available at* https://www.cftc.gov/PressRoom/PressReleases/8079-19. The Climate-Related Market Risk Subcommittee includes members from financial markets, the banking and insurance sectors, as well as the agricultural and energy markets, data and intelligence service providers, the environmental and sustainability public policy sector, and academic disciplines focused on climate change, adaptation, public policy, and finance. The list of current Subcommittee members is *available at* https://www.cftc.gov/About/CFTCCommittees/MarketRiskAdvisoryCommittee/mrac_subcommitteemembers.html.

[4] A few subcommittee members filed individual statements, including Citi, JPMorgan Chase, Morgan Stanley, Vanguard, and BNP Paribas. The full statements are *available at* https://www.cftc.gov/About/AdvisoryCommittees/MarketRiskAdvisory/MRAC_Reports.html.

[5] *See* CFTC’s report, at page V. The Department of Labor issued a proposal in June related to ERISA plans investing in ESG-related investments. ICI Memorandum No. 32555 (June 26,

2020), which summarizes the proposal, is *available at* https://www.ici.org/my_ici/memorandum/memo32552.

[6] *See* CFTC's report, at pages 35-36.

[7] To develop this guidance, the report states that the US should study the establishment of a Standards Developing Organization (SDO) composed of public and private sector members.

[8] The SEC's 2010 Guidance on climate risk disclosure (February 2, 2010) is *available at* https://www.sec.gov/rules/interp/2010/33-9106.pdf.

[9] The report explains that the SEC has existing authority to require disclosure of material information to regulators, investors, customers, and counterparties under Regulation S-K of the Securities Act and the SEC's 2010 Guidance on climate risk disclosure. However, it notes that "the guidance has not had a significant impact on actual climate risk disclosures by companies because of its lack of specificity and uneven application."