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To The Financial Stability Board – Task Force on Climate-Related Financial Disclosures ("TCFD")

By email to info@fsb-tcfd.org

1st May 2016

Dear Sirs,

Public Consultation

Hermes Equity Ownership Services welcomes the opportunity to provide our comments on this consultation on climate-related financial disclosures. By way of background, Hermes is one of the largest asset managers in the City of London, and is wholly owned by the BT Pension Scheme, the UK's largest corporate pension scheme. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the rest of the world, including The BBC Pension Scheme, The Ireland Strategic Investment Fund, PNO Media and VicSuper.

In all, Hermes EOS advises over 40 clients with assets worth a total of over $240 billion (as at 31 March 2016). As the world's largest stewardship service provider, Hermes EOS engages with around 500 of the world's largest companies across all major sectors and geographies on the full range of issues relevant to long term shareholder value. These include corporate governance, long term strategy and key risks and opportunities, including those related to climate change.

Hermes is a member of the Institutional Investor Group on Climate Change and we support the submissions it has made to the Task Force to date[1]. We are also members of 'Aiming for A', a coalition of investors[2] committed to improving corporate disclosure and action on climate change. Consistent with our supportive, but stretching approach to corporate engagement, the coalition has coordinated the filing of a number of shareholder resolutions requesting enhanced disclosure of climate-related risks and associated mitigating actions at a number of oil & gas and mining companies. These include BP and Royal Dutch Shell in 2015 and the mining companies Anglo American, Glencore and Rio Tinto in 2016. So far, all such resolutions have been passed with more than 95% investor approval, demonstrating broad investor appetite for enhanced disclosure.

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[1] https://www.fsb-tcfd.org/wp-content/uploads/2016/02/IIGCC-Presentation-Slides-Feb-9-2016.pdf

[2] Aiming for A includes: Hermes Investment Management on behalf of its stewardship services clients, the Local Authority Pension Fund Forum and the largest members of the Church Investors Group, Sarasin & Partners, Pensions Trust and Rathbone Greenbank Investments.

General comments

Investors have long supported stronger action on climate change, based on the clear understanding that the long term benefits of minimising the physical risks of climate change outweigh the shorter term transition costs. However, market and policy failures still leave a large proportion of economic activity and associated investment misaligned to this outcome. Resolving this conflict leads to a shorter term 'transition' risk (and opportunities), while past and future emissions threaten longer-term 'physical' risks to the portfolio.

Climate-related financial disclosures should therefore focus both on:

- **Climate risks:** the risks arising as the economy moves to lower carbon, together with the physical risk of climate change itself;
- **Low carbon alignment:** the progress made and future plans to align value-creation towards building a lower carbon economy.

The reporting of climate-related financial disclosures should be of sufficient scope to cover the major players at each link in the investment cycle. Disclosure can be viewed from the perspective to two broad groups:

- By investment targets (e.g. companies[3]) to investors
- By investors, including investment intermediaries (e.g. asset managers) to their clients and, ultimately investors to beneficiaries

Reporting by Investment Targets (e.g. companies)

Climate risk: The transition to a low carbon economy poses a potentially material - even existential - risk to certain types of investment and the changing climate introduces physical risks. This poses a strategic challenge for which there is no simple metric or indicator. Rather, a strategic appraisal of risks and opportunities is required. This, together with the uncertainty of the transition itself, leads investors to require the following type of disclosure:

- The results of a "stress-test" of the value and performance of each materially exposed investment to a range of climate change scenarios. These should be communicated using both narrative reporting and the estimated quantified value-at-risk (%), together with potential mitigating actions.
- To ensure comparability of results at level that meets investor requirements, the stress-tests must be reasonably standardised through guidelines appropriately tailored to the asset class, sector and geographies of the investment concerned.

Low carbon alignment: There are a range of dimensions of reporting which help describe the current and future planned alignment of economic activities towards a low carbon economy which help mitigate climate risk. The 'Aiming for A' enhanced disclosure framework covers the main areas as follows:

- Ongoing operational emissions management;
- Low-carbon energy research and development (R&D) and investment strategies;
- Relevant strategic key performance indicators (KPIs) and executive incentives; and
- Public policy positions relating to climate change.

Our hope is that the TFCD can help establish a common framework for corporate reporting across the market which meets investor requirements and which dispenses with the need for further co-filing of shareholder resolutions.

Reporting by investors

It is important for investors to report on emerging climate risks and low carbon alignment, given their long term investment horizon and the potential long term impacts. Monitoring rising

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[33] Companies across all sectors, including banking (which arguably could be in a special category, together with other classes of investment such as real-estate, infrastructure etc.

climate risks, together with the pace of alignment to a lower carbon economy will help give the necessary early warning of whether sufficient action is being taken.

Climate risk: disclosure of the portfolio level risks arising from climate change, including each of transition, liability and physical risks over time.

Low carbon alignment: disclosure of the extent to which an investor, through its portfolio investment strategy and other actions, is achieving alignment with the move to a low carbon economy. This would include the following areas:

- The profile of investments in sectors aligned to a low carbon economy
- The investors' stewardship activities including corporate engagement and voting recommendations on climate-related issue
- Investors' public policy position and advocacy on climate change

Currently, the methodologies and tools to analyse portfolio climate risk are emergent and not established. This reflects, in part, the lack of understanding and disclosure of investment target risk. Similarly, methodologies for reporting low carbon alignment are still in development, often stimulated by investors' commitment as members of the Portfolio Decarbonisation Coalition[4]. **It will therefore be appropriate to take a non-prescriptive and voluntary approach to investor reporting which enables innovation of best practice over time**. **The nature of reporting will also appropriately different between asset owners, asset managers and other regulated intermediaries and should be the subject of further work.** In making this submission, we recognise that some asset owners are concerned that disclosure will be costly and potentially not relevant. Meanwhile, others are concerned that unless asset managers are under an obligation to report, it will be difficult to obtain the necessary data in a timely manner and to the appropriate quality.

Meanwhile, improvements in disclosure by investment targets will improve investors' understanding of and ability to disclose climate risk and low carbon alignment and so should be the first priority.

We attach further details in answer to the consultation in the Appendix. If you would like to discuss any of these comments further, then please feel free to contact me at 020 7680 2110 or bruce.duguid@hermes-investment.com.

Yours sincerely,

Bruce Duguid
Director, Hermes EOS

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[4] A coalition of investors representing US$600B of assets under management (see http://unepfi.org/pdc)

Appendix: Responses to key questions posed by The Financial Stability Board – Task Force on Climate-Related Financial Disclosures ("TCFD")

The following additional comments use the heading structure provided by the TCFD in its consultation questions:

<u>Coverage and audiences</u>

- The reporting of climate-related financial disclosures should be of sufficient scope to cover the major players at each link in the investment cycle including: companies, banks including lending and advisory, insurance providers, stock exchanges, investment consultants, asset managers and asset owners.
- Such reporting should be carried out by each type of investor, including asset owners and institutional investors such as corporate pension schemes and endowments, together with retail investors of both long and shorter-term products.

<u>Climate-risk dimension</u>

- We support the framework which compartmentalises climate risk into 'transition', 'liability' and 'physical' risks. We believe that for most sectors and asset classes for at least the next decade, the risks will arise broadly in that order. Our focus is therefore primarily on the disclosure of transition risk, together with the associated 'liability' risks of the transition and the activities taken to mitigate these.

<u>Disclosure of climate-related risks by target investments</u>

- We believe that climate change-related risks present a potentially significant material - even existential - risk to certain types of investment, depending on the nature of the transition to a low carbon economy that may be experienced (which, in turn depend on policy and regulatory instruments, available technologies and the pace of transition). However, the risk is generally complex and strategic in nature and cannot be easily modelled using quantitative data alone.
- For this type of risk, the type of reporting primarily required of exposed target investments is a forward looking, risk-based reporting approach outlining the potential risks and opportunities for an investment when stress-tested under a range of representative low carbon scenarios over time. Although the results of this type of analysis will most likely be reported using narrative form, it should also involve a summary of the anticipated materiality of climate-related risks, including a broad quantification of the net asset value-at-risk under certain scenarios and their underlying key assumptions.
- Given the subjective nature of this type of risk assessment, in order for different investors to be able to compare the appraisal of many different target investments, a reasonably standard type of stress-testing will need to be prescribed through a set of guidelines appropriately tailored to the asset class, sector and relevant geographies of the investment concerned.
- This type of analysis will depend upon access to a variety of data-sources and it is difficult to determine a single metric or limited set of metrics which will summarise the risks posed for investors as the materiality of different factors will vary by situation. However, it will significantly improve risk appraisal across all investment targets if there is a move towards transparent and consistent reporting of greenhouse gas emissions across all companies/ investments.
- Aiming for A has developed a standard framework for corporate disclosure of climate risks which focuses on the following reporting:
    - Ongoing operational emissions management;
    - Asset portfolio resilience to the International Energy Agency's (IEA's) scenarios;
    - Low-carbon energy research and development (R&D) and investment strategies;
    - Relevant strategic key performance indicators (KPIs) and executive incentives; and
    - Public policy positions relating to climate change.
- Good examples of the type of risk reporting on climate change provided by companies include:

- BHP Billiton: in its report: Climate Change: Portfolio Analysis[5], BHP Billiton outlines the impact to earnings (EBITDA) from a range of low carbon scenarios over a period of 20 years, including scenarios consistent with a 2C outcome.
- Statoil: In its 2015 Annual Report[6], Statoil has also comprehensively analysed the value-at-risk to the net present value (NPV) of its current portfolio of assets from a range of low carbon scenarios, including one consistent with a 2C outcome.
- BP has also defined a range of scenarios, including a low carbon scenario, against which it seeks to stress test and future-proof its portfolio of investments, as part of its Energy Outlook 2016[7], although its low carbon scenario is not consistent with 2C and it has not translated this into a statement of the value-at-risk.

Disclosure of risks among investment portfolios

- The climate-related risk in an investment portfolio derive from the risks contained within its individual investments. Improvements in the appraisal and communication of climate-related target investment risk at the sector and asset class level will therefore improve the understanding and management of investment portfolio risk.
- Investment portfolio risk will generally be the weighted exposure of the risks in each investment. However, these risks will sit across multiple dimensions across time. Complex portfolio effects may take place which may either compound these risks through potentially unforeseen feed-back loops or which reduce these through hedging or diversification.
- At present, the tools to analyse these investment level risks are emergent and not yet mature. Accordingly, more research is required to develop a comprehensive suite of investment climate risk-related appraisal tools.
- It is likely that there is no single metric which will summarise investment climate-related risks. Whilst it is somewhat revealing to measure the annual carbon footprint associated with an investment portfolio and to compare this to a typical benchmark portfolio, this only the beginning of an inquiry into climate-related risks and does not in and of itself give an immediate response to the nature or extent of these risks.
- At Hermes, we follow a 4-part framework for climate-related risk appraisal and management as follows8:
  - Awareness of carbon risk exposure in investment portfolios
  - Integrating carbon risk in investment decisions
  - Directly managing and engaging to reduce carbon risk
  - Advocating to promote market transformation
- Hermes has also signed the Montreal Pledge and joined the Portfolio Decarbonisation Coalition (PDC)[9]. The coalition of investors, representing US$600B of assets under management, aims to understand and measure the risks and opportunities from climate change and the transition to a low-carbon economy and align their portfolio with the low-carbon economy. The coalition members and signatories to the pledge have all published their carbon footprint and shared their strategies on how they measure and manage carbon risks in their investment portfolios.
- Good examples of how a range of investors address climate risk measurement and reporting is available through the Portfolio Decarbonisation case studies[10] and include among others Amundi, Australain Ethical, ERAFP, Storebrand, and Hermes.
- While it is somewhat revealing to measure the annual carbon footprint associated with an investment portfolio, this is only the beginning of an inquiry into climate-related risks and low carbon alignment. It does not, of itself, give an immediate insight into the nature or extent of these risks.

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[5] http://www.bhpbilliton.com/~/media/5874999cef0a41a59403d13e3f8de4ee.ashx
[6] http://www.statoil.com/en/InvestorCentre/AnnualReport/Pages/default.aspx
[7] https://www.bp.com/content/dam/bp/pdf/energy-economics/energy-outlook-2016/bp-energy-outlook-2016.pdf
[8] "Turning down the heat", our approach to managing carbon risk in investment portfolios, Hermes Investment Management, https://www.hermes-investment.com/wp-content/uploads/2015/12/Hermes-Corporate-Turning-Down-the-Heat-011215.pdf
[9] http://unepfi.org/pdc
[10] www.unepfi.org/fileadmin/documents/FromDisclosureToAction.pdf

Asset class dimension

- The most exposed asset classes are likely to be: equities (particularly energy providers, utilities, energy intensive industries and transportation), real estate, and certain categories of infrastructure (particularly energy and transport-related) as well as agricultural land and forestry.
- Real estate is mostly affected by the liability risk from increasing regulation and longer term physical risks, it also represent the sector with one of the biggest opportunities in the transition phase.

Intermediary user scope

- Good examples of industry analysis on climate change include the following:
  - Climate change, a business revolution? The Carbon Trust (2008)[11]
  - Investing in a time of climate change, Mercer (2015)[12]
  - Unhedgable Risk, how climate change sentiments impacts investment, Cambridge Institute of Sustainability Leadership[13]

- Leading broker research on the impacts of climate change includes:
  - Various reports by Carbon Tracker, commencing with Unburnable Carbon (2011)[14]
  - Carbon Disclosure Project sector reports (2015-16)[15]
  - Energy Darwinism, Citibank, August 2016[16]
  - A Call to Action - Climate Change Solutions Primer, Bank of America Merrill Lynch, December 2015[17]
  - Oil & Carbon Revisited, value at risk from unburnable reserves, HSBC, January 2013[18]

Looking ahead

- TFCD should aim to consolidate the case for enhanced climate-related financial disclosure. This should include not only climate risk, but also transition alignment
- Our hope is that the TFCD can help establish a common framework for corporate reporting across the market which can dispense with the need for further co-filing of shareholder resolutions. This should enable comparison of progress in reducing climate risk and improving low carbon alignment both between companies and investors and also over time.
- The key barrier that TFCD may face in recommending enhanced disclosure is the claim that climate risk is not yet material and that when it is, existing reporting frameworks will be sufficient. The view that climate risk is not material may arise from a perspective that 'transition' risk remains some time away and is uncertain, while 'physical' risk is even further out. These arguments can be rebutted as follows:
  - There is too little disclosure to be able to confirm a view that climate risks are not yet material. The nature, scale and timing of the transition are uncertain and will change over time, so that an analysis of risks against various scenarios is required. The appropriate analysis is complex and would benefit from transparency and peer review, which requires disclosure.
  - Climate risks – both transition and physical - will rise over time, potentially in a non-linear manner. Given the future potential magnitude of such risks, which could threaten financial stability and long-term prosperity, it is appropriate to commence reporting now, before the risks are large and it is too late to mitigate.

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[11] https://www.carbontrust.com/media/84956/ctc740-climate-change-a-business-revolution.pdf
[12] http://www.mercer.com/our-thinking/investing-in-a-time-of-climate-change.html
[13] http://www.cisl.cam.ac.uk/publications/sustainable-finance-publications/unhedgeable-risk
[14] http://www.carbontracker.org/our-work/
[15] https://www.cdp.net/en-US/Pages/events/2015/sector-research-for-investors.aspx
[16] Proprietary document – request from broker
[17] Proprietary document – request from broker
[18] Proprietary document – request from broker

Disclosure of the extent of alignment to low carbon outcomes is critical to enabling the necessary action to reduce the risk itself. Establishing a disclosure regime is therefore itself a mitigation tool.