Intervention Update

UK financial regulators are missing in action on company failures to disclose material climate-related information

Executive Summary

Climate change is radically transforming the world we live in, including our economy. Human activity has already caused 1°C of global warming and the physical impacts are here now. More frequent and severe droughts and storms, rising sea levels and unprecedented weather patterns are disrupting businesses across the globe. At the same time, transition mega-trends driven by climate-related regulation, technology advances, and consumer demand are deeply reshaping markets.

The world's biggest investors are demanding that companies provide detailed climate-related disclosures in their financial reports. As managers of our pensions and savings, they know that climate change and the zero-carbon transition create enormous risks and opportunities for individual businesses and the entire economy. They see that without investment grade disclosures, they will be unable to meet their own duties to allocate and steward our capital through these changes.

Because of clear investor expectations, companies now need to disclose information about risks, trends and impacts associated with climate change as a matter of law. Clear materiality signals from investors mean that listed companies in the UK need to report how they have taken into account the resilience of the company's business model and its risks, uncertainties and viability in light of climate change. Many will need to reflect this information in their financial accounts.

Evidence that climate-related reporting in the UK falls far below investor expectations indicates that many companies are likely breaching the law. While there has been some improvement in recent years, many of the UK's biggest companies still fail to disclose any information at all about the implications of climate change for their business. Even among those that do; only a very select few disclose information with the detail that investors are demanding.

The UK's financial regulators are failing to adequately supervise firms and enforce the law. In recent years, ClientEarth has reported numerous companies to the Financial Reporting Council (**FRC**) and Financial Conduct Authority (**FCA**) for failing to adequately report climate change-related information. In all cases, the reported companies were in high-risk sectors, but disclosed no meaningful information about climate change-related risks in their annual reports. Despite this, neither the FRC nor FCA have ever made a public finding of non-compliance.

The UK's financial regulators must hold companies, directors and auditors accountable for breaches of reporting requirements. Recent public statements and guidance by the UK's financial regulators on climate change-related reporting are welcome. But unless these are backed up by appropriate supervisory and enforcement actions, companies will not be sufficiently incentivised to avoid greenwash and provide the fair, balanced and comprehensive disclosures required by law.

ClientEarth is calling on government and regulators to take urgent action to close the enforcement gap. This update summarises ClientEarth's view of the law as it applies to company reporting and climate change, and our experience with making complaints to the FRC and the FCA. It calls for urgent action to ensure that those managing our savings and our pensions have the information they need to prudently allocate and steward our capital as the disruptive impacts of climate change and the net zero-carbon transition accelerate.

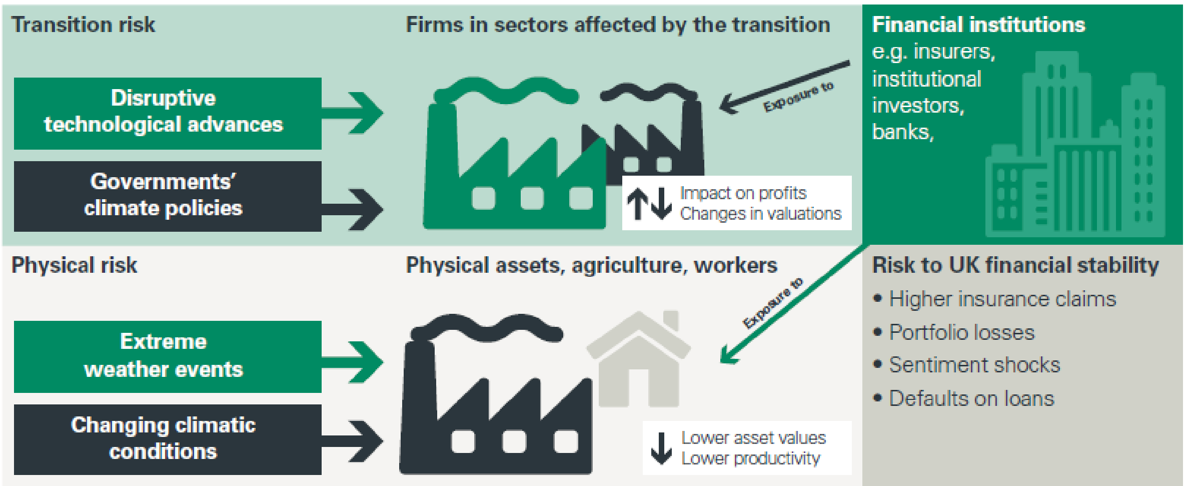
Financial risks associated with climate change and the net zero-carbon transition

It is now widely accepted that climate change will create physical, social and economic disruption on an unprecedented scale. With roughly 1°C of global warming already driven by human activity, the physical impacts of climate change are being felt now. Droughts are becoming more extreme, storms are increasing in severity and sea levels are rising. These impacts will increase dramatically in the future, even under the most optimistic scenarios.

The impacts of climate change are not just physical. Efforts to address and adjust to its effects are fundamentally reshaping economies. Decisive actions by governments, companies and civil society, combined with sharply declining costs of renewable energy and shifting consumer preferences are rapidly accelerating the transition to a low carbon economy.

For business and investors, the financial risks of climate change are now well known. Following a taxonomy developed by the Bank of England they are often categorised into physical, transition, and liability risks. Physical risks arise directly from the impacts of climate change, transition risk arises from society's response to climate change, and liability risks may arise where affected parties seek to recover climate change-related financial losses. There is also growing awareness of the systemic impacts these risks will have for the entire economy.

Figure 1. Primary channels for climate-related financial risks



Source: Bank of England, 'The Bank of England's Response to Climate Change' (2017)

Examples of Climate-related Financial Risks

- **Physical Risk:** The insurance sector has seen increasing losses due to extreme weather events. Many of these weather events have been exacerbated by climate change, with insured losses in 2017 being the highest on record at $140 billion.
- **Transition Risk:** Between 2016 and 2018, General Electric Company lost 74% of its market capitalization. Analysis by the Institute for Energy Economics and Financial Analysis found this value destruction largely stemmed from its misjudgement of the energy transition, and the collapse of the thermal power market.
- **Liability Risk:** Oil and gas giant ExxonMobil has been subject to increasing litigation in relation to its contribution to (and alleged concealment of) climate change. This includes a lawsuit by the New York attorney general for allegedly defrauding investors by deliberately downplaying risks from climate change.

The law – UK companies must disclose material information

Companies that are publicly listed in the UK are required by law to disclose detailed information about their business to the market. Alongside audited financial accounts, this includes a wide range of other information, including a description of:

- the company's strategy, objectives and business model;
- the principal risks and uncertainties facing the company;
- environmental matters, including the impacts of the company's business;
- performance metrics to assess progress against objectives, strategy and impacts; and
- the viability and prospects of the company over the long term.

(See Annex for further details)

Because the UK has adopted a principles-based approach to corporate reporting, the exact contents of what must be disclosed to satisfy these requirements is not specified in legislation. Instead, **companies are expected to apply the principle of 'materiality'** to determine what information to include. While the concept of 'materiality' is not itself defined in legislation, the FRC Guidance on the Strategic Report explains that:

> '*information is material if its omission or misrepresentation could reasonably be expected to influence the economic decisions shareholders take on the basis of the annual report as a whole*.'

This definition makes clear that **the core touchstone of 'materiality' is whether or not particular information would *reasonably be expected* to influence investor decision-making**. In addition, the FRC Guidance highlights that both quantitative and qualitative factors must be considered, as well as implications for long-term value generation.

Company directors do retain some discretion in making materiality judgments. What the FRC has made clear however, is that this discretion is not absolute. Directors, management and their advisers and auditors need take into account investors' reasonable expectations. In this context, **investors' communications and public statements about the matters they consider influential in their decision-making are highly relevant.** The behaviour of peers and regulatory expectations also need to be considered.

FRC Statement on the Government's Green Finance Strategy (July 2019)

'The Boards of UK companies have a responsibility to consider their impact on the environment and the likely consequences of any business decisions in the long-term.

They should therefore address, and where relevant report on, the effects of climate change *(both direct and indirect). Reporting should set out how the company has taken into account the resilience of the company's business model and its risks, uncertainties and viability in both the immediate and longer-term in light of climate change.*

Companies should also reflect the current or future impacts of climate change on their financial position*, for example in the valuation of their assets, assumptions used in impairment testing, depreciation rates, decommissioning, restoration and other similar liabilities and financial risk disclosures.'*

Climate change is material for all listed UK businesses

The business risks, opportunities and impacts of climate change and the net zero-carbon transition now constitute material information, which **must be reported by all companies listed in the UK under existing disclosure laws**. This is because evidence of the materiality of climate change-related information to investors is now overwhelming.

The magnitude and systemic nature of climate change mean that companies across every geography and sector will be affected. Government and regulators have been increasingly explicit about their disclosure expectations and leading businesses are setting a high and increasing standard. Most critically for the legal test, **investors have been loud and clear that detailed climate-related information is highly relevant to their decision-making**.

Investors managing trillions in assets have repeatedly **demanded that companies provide high quality climate change-related disclosures in their financial reports.** As managers of our pensions and savings, these investors see that without investment-grade disclosures, they will be unable to meet their own duties to prudently allocate and steward our capital.

'We expect companies to … [d]isclose and integrate into annual reports and financial filings, the company's view of and response to its material climate change risks and opportunities, including those arising from carbon regulations and physical climate change risks' – Institutional Investors Group on Climate Change (2012)

'As institutional investors and consistent with our fiduciary duty to our beneficiaries, we will work with the companies in which we invest to ensure that they are minimising and disclosing the risks and maximizing the opportunities presented by climate change and climate policy' – Global Investment Statement on Climate Change (2014)

'Preparing for and addressing the threat posed by climate change requires that companies across all sectors take a strategic, long-term approach — and provide robust disclosure to investors about these efforts.' – *State Street (2019)*

In light of unequivocal statements by the world's biggest investors, we do not see how a director of any listed company in the UK can reasonably claim that information about how its business is managing risks and opportunities from climate change is not relevant to investor decision-making. **This information is therefore material and must be disclosed.**

Furthermore, this information must be disclosed with the granularity and level of detail, which investors now reasonably expect. **Given their status as the global industry standard, the recommendations produced by the Task Force on Climate-related Financial Disclosures (TCFD) are now a de facto legal benchmark and must be the starting point.**

This means that companies need to report their governance, strategy, risk management, and metrics and targets for managing climate change-related risks and impacts. In many cases, companies will also need to reflect these risks and trends in the assumptions and estimates used in the preparation of their financial accounts.

As a recent report by asset manager Sarasin & Partners has noted, **unless companies ensure consistency between identified climate change-related trends and their accounting assumptions, they risk overstating their financial position.** Ultimately, this could result in shareholder capital being jeopardised and the payment of illegal dividends.

Financial regulators are failing investors on climate-change related reporting

Despite what we believe are now clear legal requirements, **many UK companies still fail to disclose meaningful information about climate change-related risks and impacts in their annual reports**. Even amongst those that do disclose climate change as a principal risk, only a select few disclose information with the detail that investors now expect.

In order to help address this information gap, in recent years, **ClientEarth has raised a number of instances of legal non-compliance with the Financial Reporting Council (FRC) and Financial Conduct Authority (FCA)** – both of whom have responsibility for overseeing corporate reporting.

In all cases, the reported companies were in high-risk sectors but disclosed no meaningful information about climate change-related financial risks in their annual reports. In our complaints, we set out detailed evidence of climate change-related risks facing the particular company, numerous examples of climate change-related disclosures by peers in the same or related sectors, and clear statements of expectation and guidance by investors and regulators.

Despite this evidence, the FRC and the FCA failed to take enforcement action against any of these companies. Except for one complaint, the regulators failed to make a determination about whether the reports complied with the law. In the one case where they did reach a decision, **the FRC sided with the company and accepted that climate change was not a risk which was material to shareholders** and did not need to be disclosed.

The annual reports for each of the reported companies showed some improvement in the year following our complaints. The majority of the companies subsequently reported climate change as a principal risk in its own right, or as relevant to another principal risk. This is a step in the right direction for the companies directly concerned. However, **failure by the FRC and FCA to take stronger action severely undermines investor demands for market-wide, decision useful information about climate change-related risks and impacts**.

Table 1: Summary of ClientEarth regulatory complaints and outcomes

Date	Company (Sector)	Climate Risk Disclosure	Outcome
8.16	Cairn Energy PLC (Oil & Gas)	None	No decision made by FRC on adequacy of 2015 annual report.
8.16	SOCO International Plc (Oil& Gas)	None	No decision made by FRC on adequacy of 2015 annual report.
8.18	Admiral Group plc (Insurance)	None	No public decision made by the FCA.
8.18	Lancashire Holdings Limited (Insurance)	None	No public decision made by the FCA.
8.18	Phoenix Group Holdings (Insurance)	None	No public decision made by the FCA.
9.18	Balfour Beatty PLC (Construction)	Very limited	No decision made by FRC on adequacy of 2017 annual report.
9.18	Bodycote PLC (Thermal Processing)	None	FRC decided that Bodycote's failure to disclose did not breach requirements.
9.18	EnQuest PLC (Oil & Gas)	None	No decision made by FRC on adequacy of 2017 annual report.
9.18	EasyJet PLC (Aviation)	None	No decision made by FRC on adequacy of 2017 annual report.

The UK's financial regulators must do better on climate change

Recently, the UK's financial regulators have released increasingly clear statements and guidance regarding their expectations about how companies manage and disclose climate change-related risks and impacts. Such statements are undoubtedly welcome. However, they are no replacement for adequate supervision and enforcement of existing legal requirements.

> *"Climate change is one of the defining issues of our time. We recognise it presents farreaching financial risks relevant to our mandates from both physical factors, such as extreme weather events, and transition risks that can arise from the process of adjustment to a carbon neutral economy. Companies should consider the likely consequence of climate change on their business decisions, in addition to meeting their responsibility to consider the company's impact on the environment. Financial risks will be minimised by achieving an orderly transition and via a collective response."*
> – Joint Statement by the BoE, FCA, FRC and tPR (June 2019)

ClientEarth's experience in making its recent complaints has revealed that **the regulators lack capacity and willingness to take strong enforcement action. They have been slow and opaque in dealing with complaints, and overly deferential in their acceptance of company directors' determinations of materiality.** Private agreements with companies to make improvements in future reports are an inadequate remedy and signal to the market.

In addition to inadequate responses to our complaints, we see limited evidence of the FRC or FCA proactively supervising and enforcing the adequate disclosure of climate-related information to remedy this situation. In our view, **unless credible and effective accountability mechanisms exist, companies will not be sufficiently incentivised to avoid greenwash and provide the fair, balanced and comprehensive disclosures required by investors and the law.**

ClientEarth calls on regulators and government to close the accountability gap

In light of these concerns, we call on the FRC and FCA to address the serious enforcement and accountability gap in relation to corporate reporting in the UK. Enforcement teams must be properly trained and resourced to supervise the scope and adequacy of corporate climate-related disclosures. Where non-compliance is identified, clear and unambiguous enforcement action must be taken. Companies, directors and auditors must be held accountable for breaches of reporting requirements.

If the FCA and FRC fail to take strong steps to address these concerns, government must step in to demand the regulators properly discharge their public duties and ensure that enforcement is prioritised as part of broader corporate governance and audit reforms. The accountability gap has now been clearly identified, so action must be taken to close it. Accountability needs to be a key pillar of the UK's Green Finance Strategy going forward.

> *"…there is a gap between the expectations of investors and reporting practice, both in the quality and granularity of information provided"* – FRC Reporting Lab (2019)

> *"[Respondents] stressed the value of consistent, comparable and high-quality disclosures of material risks to enable issuers and investors to take account of climate change risks."*
> – FCA, Feedback to DP18/8 (2019)

What can investors do?

In order to meet their own fiduciary duties to their clients, **institutional investors are required to take financially material factors into account in their decision-making**. In relation to climate change-related risks and impacts, unless companies provide the data and information necessary for analysis, investors will be unable to achieve their objectives.

Importantly, **the UK's corporate reporting framework is designed to provide investors with material information necessary to make investment and stewardship decisions.** Investors' reasonable expectations are directly relevant to the materiality test which companies are required to apply to make their disclosures.

This means that investors have significant power to set expectations about what information they require. This includes expectations about the significance and materiality of climate-related information and could extend to expectations about reporting in line with the TCFD recommendations; demands for disclosure of Paris-aligned business strategies, capital allocation plans, and lobbying practices; and setting of clear emission reduction targets.

Given the powers at their disposal, **investors should take urgent action to make their expectations on climate reporting clear to financial regulators, portfolio companies and auditors**, to ensure that they are able to properly fulfil duties to their beneficiaries and clients. Where company reporting fails to meet investor expectations then they should pursue a proactive engagement strategy underpinned by a clearly articulated AGM voting strategy.

Actions for investors

- **Notify regulators of expectations and demand effective enforcement.** Investors that take climate change seriously should formally notify the FRC and the FCA that they expect all UK listed companies to provide detailed disclosures about how they are managing the risks and opportunities from climate change and the zero-carbon transition, in line with the recommendations of the TCFD.

- **Formally place companies, directors and auditors on notice of expectations.** Climate-aware investors should make their expectations clear by formally and publicly placing companies, directors and auditors on notice.

- **Engage and vote to enforce expectations.** Where company reporting fails to meet investor expectations then they should pursue a proactive engagement strategy underpinned by a clearly articulated AGM voting strategy targeting directors, audit committee chairs and members, auditors and approvals of the annual report and accounts.

In ClientEarth's view, investors that claim to take climate change seriously but fail to back this up with strong action to ensure they have the information they need in order to do so, face increasing reputational and legal risks themselves.

Annex

Examples of legal provisions relevant to climate risk disclosure (not comprehensive)

Law	Disclosure Requirement
DTR 4.1.8 R	*"a description of the principal risks and uncertainties facing the issuer"*
DTR 1A.3.2 R	*"an issuer must take all reasonable care to ensure that any information it [formally disclose] is not misleading, false or deceptive and does not omit anything likely to affect the import of the information."*
CA 414C(2)(a)	*"a fair review of the company's business"*
CA 414C(2)(b)	*"a description of the principal risks and uncertainties facing the company"*
CA 414C(7)(a)	*"the main trends and factors likely to affect the future development, performance and position of the company's business, …"*
CGC 2.2 & LR 9.8.6	*"Taking account of the company's current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary."*

Accounting requirements relevant to climate risk disclosure (not comprehensive)

Standard	Possible climate risk implications
Recognition of mineral resources and reserves (IFRS 6)	Climate-related risks may affect: whether certain expenses satisfy the definition of an asset and thus can be recognised (e.g. as property, plant and equipment or an intangible asset); and the estimated useful lives of assets, and therefore the amount of depreciation or amortisation recognised each year.
Fair value measurements (IFRS 13)	When the fair value of a particular asset is impacted by climate-related risks, the entity may need to disclose how climate-related risk is factored into the calculations
Impairments (IAS 36, IFRS 6, IAS 41)	The carrying value of assets such as property, plant and equipment, assets recognised in relation to mineral resources, intangible assets and goodwill could be overstated if the impairment calculations do not take the impact of climate-related risks into account.
Asset retirement obligations (IAS 16, IAS 37)	Potential climate-related risks and uncertainties may be taken into account in determining the best estimate of a provision. This could include an increase of provisions recognised for decommissioning a plant or rehabilitating environmental damage in extractive industries due to regulatory changes or shortened project lives
True and fair view/fair presentation requirement (CA s 393, IAS 1)	The 'true and fair view requirement likely requires that notes to the financial statements provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them. In the context of climate-related risks, information will be relevant if investors could reasonably expect that climate-related risks or other emerging risks have a significant impact on the entity and this would influence investors' decisions.

See further, IASB, 'IFRS Standards and climate-related disclosures' (2019)