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Brief

Updated EU Non-Binding Guidelines on Non-Financial Reporting for Companies and Financial Institutions

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Abstract

FEEM Policy Brief

On the 18th of June 2019, the European Commission has issued an update of the Non-Binding Guidelines on Non-Financial Reporting (NBG). This document takes into account the Recommendations of the Task Force on Climate-related Financial Disclosure (TCFD), released in June 2017, and the Technical Expert Group on Sustainable Finance (TEG) Report, first published in January 2019. These Guidelines also consider the stakeholder feedback on the TEG's work, and the results of a targeted online consultation carried out by the services of the European Commission in February-March 2019. The document aims at providing a useful insight on how companies and financial institutions should approach the climate-related financial disclosure, and offer an in-depth commentary on what the Commission intends by reporting in terms of climate-related risks, dependencies and opportunities, business model, policies and due diligence, outcomes, principal risks and their management, and Key Performance Indicators (KPI). This recent update is part of the EU Action Plan on Financing Sustainable Growth, first published on the 8th of March 2018, which represents one of the pivotal steps towards the implementation of the Paris Agreement pledge and the EU's agenda for sustainable development.

01 Introduction

The 2015 Paris Agreement on Climate Change, the United Nations' Sustainable Development Goals and the Special Report of the Intergovernmental Panel on Climate Change (October 2018) all call for accelerated and decisive action to reduce greenhouse gas (GHG) emissions and to create a low-carbon and climate-resilient economy. The EU has agreed on ambitious targets for 2030 regarding GHG emission reductions, renewable energy and energy efficiency, and has approved rules on GHG emissions from land use as well as emissions targets for cars and vans (European Commission, 2019a).

To meet the EU's energy and climate 2030 targets an estimated amount of €180 billion per year is needed, but further funds are necessary to achieve climate neutrality by 2050. Hence, business opportunities are significant, and the private sector involvement, in terms of commitment and capital investment, appears crucial.

However, the risks that climate change poses to the business activities of companies and financial institutions, and, viceversa, the potentially negative climate impacts of businesses are also significant and need to be examined thoroughly. Weather-related disasters caused a record of €283 billion in economic damages in 2017 and could affect up to two-thirds of the European population by 2100 compared with 5% today (European Commission, 2019a).

As part of the EU Action Plan on Financing Sustainable Growth and alongside with the NBG update, several other actions have been proposed, in particular:

- ***A unified EU classification system (taxonomy)***

The aim is to provide a harmonised set of criteria for determining whether an economic activity should be viewed as environmentally-sustainable. This will lay the foundations for the future establishment of standards and labels for sustainable financial products, as noted in the Action Plan on Sustainable Finance.

- ***EU labels for green financial products***

The establishment of a European label system should help investors to easily identify financial products that are compliant with green or low-carbon criteria.

- ***Investors' duties and disclosures***

This action aims at enhancing consistency and clarity on how institutional investors (i.e. asset managers, insurance companies, pension funds, or investment advisors) should integrate ESG factors when making investment decisions.

- ***Low-carbon benchmarks***

The EU intends to design a new category of benchmarks, including the low-carbon benchmark or "decarbonised" version of standard indices and the positive-carbon impact benchmarks. This new market standard should indicate companies' carbon footprint and provide investors with further information on portfolios' carbon footprint.

- *Green supporting factor*

The introduction of a green supporting factor is intended to encourage banks to incorporate into their risk management processes climate-related r/o. This should help and support financial institutions that contribute to funding sustainable projects. In brief, better disclosure of climate-related information by companies and financial institutions can help to reorient capital towards sustainable investment, manage financial risks, and foster transparency and long-termism in financial and economic activity.

02 Key Features of the NBG Update

The NBG update is built upon the Non-Financial Reporting Directive (2014/95/EU), the old version of Non-Binding Guidelines on Non-Financial Reporting (published by the Commission in June 2017), and integrates the TCFD Recommendations. In particular, it aims to novate and clarify some of the six key principles for good non-financial reporting, namely: (i) material; (ii) fair, balanced and understandable; (iii) comprehensive but concise; (iv) strategic and forward-looking; (v) stakeholder oriented; (vi) consistent and coherent.

In addition, it provides further guidance on the five reporting areas listed in the Non-Financial Reporting Directive (Business Model, Policies and Due Diligence Processes, Outcomes, Principal Risks and their Management, GHG Emissions).

The most important clarification regards the materiality principle and, more specifically, in relation to the impact of [the company's] activities, a double perspective has been suggested:

- *The reference to the company's "development, performance [and] position" indicates financial materiality, in the broad sense of affecting the value of the company. Climate-related information should be reported if it is necessary for an understanding of the development, performance and position of the company. This perspective is typically of most interest to investors.*

- *The reference to "impact of [the company's] activities" indicates environmental and social materiality. Climate-related information should be reported if it is necessary for an understanding of the external impacts of the company. This perspective is typically of most interest to citizens, consumers, employees, business partners, communities and civil society organisations. However, an increasing number of investors also need to know about the climate impacts of investee companies in order to better understand and measure the climate impacts of their investment portfolios.*

As it appears clear, the NBG update has a wider spectrum than the one offered by the TCFD. The latter, in fact, has a financial materiality perspective only, while the NBG tries to deepen the analysis and also engage non-financial aspects. Notably, since the TCFD Recommendations and the NBG follow a different logical path, the document identifies the sections in which the two approaches overlap. Extensive mapping of this intersection is offered in the second annex of the document.

For what concerns the recommendations on the Business Model, the Policies and Due Diligence Processes, the Outcomes and the Principal Risks and their Management, the document provides a well-defined set of specific disclosure instructions and further guidance on the type of supplementary information that it would be desirable to disclose with the aim of expanding as much as possible the information perimeter. Since the requirements of the Non-Financial Reporting Directive apply to large listed companies, banks and insurance companies, the proposed disclosure does not take into account any of the sector-specific features. However, an annex containing further guidance for banks and insurance companies is offered, in order to help these institutions in this exercise and guide them when disclosing the information is recommended.

03 Reporting areas

The recommendations on the five reporting areas are the following.

- ***Business Model***

Company's view of how climate change impacts its business strategies and how its activities can affect the climate over time are relevant information for the stakeholders.

The document lists a set of recommended disclosures that cover the description of the impact of climate-related risks and opportunities (r/o) on the company's business model, strategy and financial planning, the ways in which the company's business model impacts the climate and the resilience of the company's business model and strategy, taking into consideration different climate-related scenarios (including at least a 2°C or lower scenario and a greater than 2°C scenario).

Further guidance is offered for more specific aspects, such as the disclosure of the business model and strategy to address physical and transition risks and opportunities, dependencies on natural capitals, resource efficiency and cost savings and scenario selection criteria.

- ***Policies and Due Diligence Processes***

With respect to the disclosure on policies and due diligence processes, the document recommends to describe the company's policy (including any climate change mitigation or adaptation policy), the targets that company has set (in terms of GHG emissions and in terms of compliance with the national and international targets), the board's oversight of climate-related r/o, and management's role in the r/o assessment and management process. In addition, a more specific list of information that the company should disclose regarding how the climate-related issues are integrated into the company's decision-making processes is provided.

- *Outcomes*

Disclosing climate-related policy outcomes is key to stakeholders for monitoring and assessing the company's development, position, performance and impact. The company then, should provide information on its performance concerning the targets it has set, demonstrating the consistency of its strategy, actions and decisions related to climate change.

- *Principal Risks and their Management*

Disclosure on risks and their management is crucial for several reasons, because, among other things, it requires a longer-term time horizon than the one considered normally during the financial risk management and because gaps in data and methodologies may in some cases make it difficult to present quantitative information about climate-related risks.

According to the document, the company should disclose information regarding the risk identification and assessment processes, their integration throughout the value chain, their management processes, and how the whole risk identification, assessment and management is integrated into the company's overall risk management.

Climate adaptation measures, detailed breakdown of principal climate-related risks by business activity and geographic location, and description of the linkages between principal climate-related risks and financial KPIs are just some examples of the further guidance that the document suggests a company should follow when reporting on climate-related issues.

- *GHG Emissions*

Regarding the GHG emissions section, the document provides an extensive explanation of the KPI that the companies should use and provide appropriate disclosure on, specifying the sector-specific indicators relevant for the particular industry, indicators on the related environmental issue, indicators on the related human capital and social issues, and indicators related to opportunities that should be included.

Policy Conclusions

This reform confirms the commitment of the European Union to improve the information quality and the communication between companies and stakeholders. Notably it contributes to set out a comprehensive approach to help firms report on their activities and processes by making them, at the same time, accountable for the strategies they intend to implement.

These Guidelines address gaps in current reporting practice, allowing for comparability across different reporting practices and integrating the TCFD's recommendations. Alongside with the Interim Report on Climate Benchmarks and Benchmark ESG Disclosure, the Report on EU Green Bond Standard and the Technical Report on EU Taxonomy, the Commission's aims at increasing confidence in climate-related disclosures, shoring up green financial products and promoting innovation in sustainable investment strategies within the broader financial eco-system.

The following is a synthetic overview of the recommendations proposed in the document.

- **Business Model**: disclosure of the impact that the company's activities have on the climate and the impact that has on the firm's businesses;
- **Policies and Due Diligence Processes**: disclosure of the company's policy, targets and board's oversight of climate-related r/o;
- **Outcomes**: Disclosure of the climate-related policy outcomes;
- **Principal Risks and their Management**: disclosure of the climate-related r/o identificationl assessment and integration into the company's overall risk management and decision-making processes;
- **GHG Emissions**: disclosure of information on sector-specific indicators, on related environmental issues, on related human capital and social issues, and on related opportunites.

References

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European Commission, 2019d, Technical Report on EU Taxonomy. Brussels.

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