Martine Botha

Senior Manager
Sustainable Finance
Tel: +27 63 792 6567
Email: martine.botha@kpmg.co.za

Sustainability disclosure standards: finding a common language

The Organisation for Economic Co-operation and Development estimates that it will cost $6.9 trillion annually through to 2030 to finance the Sustainable Development Goals.[1] The capital markets play a crucial role in mobilising this capital and allocating it towards more sustainable alternatives. As the second largest group of asset owners behind pension funds, insurers play a key role in influencing the allocation of this capital and ensuring that their businesses operate in a way that supports the transition.

As more funding is channelled towards sustainable finance initiatives, greenwashing is becoming rife. Recently the American Securities Exchange Commission (SEC) commenced investigations into a large bank[2] for its questionable "green investments", which has sent a strong message to the market. The risk of getting fined or even losing their operating licenses, has sent banks and insurers scrambling to understand what they can and can't label as "green" or "sustainable" products. Like nutrition information on food labels informs customers about what the food contains, customers and investors want assurance that their capital is being used as anticipated. With sustainability-linked assets at USD $35.3 trillion, investors want to know that investee companies are channelling their profits for purpose, not just contributing to a polluting bottom line. In a similar vein, customers need assurance that their assets will be protected if there are dramatic shifts in weather patterns. If we were to undergo significant climate change, would insurers remain solvent, or would we be headed for another financial crisis?

What we require is a common language to identify, frame and report on these risks. This article looks at what is being done to streamline this across three areas – impact analysis from a risk perspective, reporting and classification.

Impact analysis from a risk perspective

Climate change poses significant risks to financial systems worldwide, as extreme weather events make economies less predictable. To anticipate these shocks, we are seeing a strong response from central banks across the world. Climate risk stress tests are becoming more mainstream and such tests could eventually feed into prudential capital requirements. In the UK for example, the Bank of England will embed climate change into its supervisory approach by the end of 2022, and actively supervise firms in line with these expectations[3]. The Bank's recent Climate Biennial Exploratory Stress Tests revealed that if there were instantaneous shocks as modelled, some insurers would breach their solvency ratios[4].

On home soil, the South African Prudential Authority (PA) is taking similar steps. In October 2021 the PA issued its Climate Risk Survey report, which investigated the responses of regulated financial institutions to specific climate risk issues. Results indicated that whilst 74% of insurers identified that climate related risks could impact their business, 65% of insurers have not undertaken any type of stress-testing[5]. Reasons for failing to run stress tests were varied; lack of data and guidance on methodologies, limited market practices and lack of resources to complete the work.

[1] Usher, Eric (2022, 21 April). *Why Financial Institutions are banking on Sustainability*. UN Environment Program. (https://www.unep.org/news-and-stories/story/why-financial-institutions-are-banking-sustainability)

[2] Robinson, Gary (2022, 26 August). DWS rocked by $1trillion SEC Greenwashing probe-reports. International Investment. (https://www.internationalinvestment.net/news/4036306/dws-rocked-usd1trillion-sec-greenwashing-probe-reports)

[3] Bank of England (2022, 8 June). Climate Change: Our response to climate change. BOE. (https://www.bankofengland.co.uk/climate-change)

[4] Bank of England (2022, 24 May). Results of the 2021 Climate Biennial Exploratory Scenario (CBES). Bank of England. (https://www.bankofengland.co.uk/stress-testing/2022/results-of-the-2021-climate-biennial-exploratory-scenario)

[5] South African Reserve Bank Prudential Authority (2021, October). Prudential Authority Climate Risk Survey Report. Prudential Authority. (https://www.resbank.co.za/content/dam/sarb/publications/prudential-authority/pa-public-awareness/financial-sector-awareness/2021/PA%20Climate%20Survey%20Report%202021.pdf)

Notwithstanding these challenges, it is fundamental that insurers keep on (or start in some cases) working on the implementation of climate risk stress testing approaches. A gradual and iterative approach, where model shortcomings and data shortages are being solved progressively during successive model estimation cycles, is probably most effective. Obtaining the first stress test results, even if still including for example significant expert judgement, allows not only for identifying data gaps and modelling issues, but also starts the process of integrating these tests in the company's processes and procedures. Climate risk stress test results will also have to feed into the own risk and solvency assessment (ORSA) and assist management and the board with strategic and operational decisions.

Furthermore, UK studies on climate risk modelling have indicated that overall costs for insurers will be lowest if early, well managed action is taken. In scenarios with no mitigation actions towards climate change, costs that initially fall on insurers would ultimately be passed on to their customers[4]. This would mean that households and businesses vulnerable to physical risks would be especially hard hit. In a market like South Africa, with Conduct high on the agenda and an already large vulnerable population, insurers will be pressed to understand the risks climate change pose and use this to inform decision making and action taking.

Reporting

Many insurers are already using multiple voluntary frameworks for their reporting, including those issued by the Global Reporting Initiative (GRI), Task Force on Climate-Related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB) – the list is extensive. Whilst these frameworks are helpful to frame and report on ESG data, they are applied inconsistently across companies and often not assured. What is needed is a reputable organisation to enter the space with enough gravitas to push a set of standard reporting frameworks across the financial services industry. The IFRS foundation has created the ISSB – International Sustainability Standards Board. By leveraging existing frameworks, such as those from the TCFD and GRI, the ISSB has created two prototypes which cover governance, strategy, and risk management. Whilst still in consultation phase, the ISSB are expecting to publish its first set of standards by the end of 2022. Whilst only voluntary, many countries have welcomed the announcement and will likely seek to legislate that compliance with the standards becomes mandatory in the upcoming years[6].

Classification

The European Union (EU) taxonomy for sustainable activities is a framework to classify "green" or "sustainable" economic activities executed in the EU[7]. While not mandatory, the EU taxonomy will be an enabler of change and encourage a transition to a greener economy. For insurers, this sort of taxonomy is a standardised language by which to assess "sustainable investment products", as well as a framework to certify insurance-based investment products (IPIBs)[8].

Launched in April 2022, South Africa followed suit and launched a Green Finance Taxonomy. Modelled on the EU's framework, it is intended to help the financial sector with clarity and certainty in selecting green investments in line with international best practice and South Africa's national policies and priorities[9]. Users of the taxonomy can evaluate an economic activity and screen performance against technical criteria: a 'do no significant harm' (DNSH) criterion as well as 'minimum social safeguards' (MSS). The taxonomy, whilst only voluntary at present, is a vital instrument to help us move towards more sustainable finance. It is also an important tool to combat greenwashing, attract investments and help companies better understand the risks associated with certain investments.

Global temperatures have already risen by 1.1 degree celsius above degrees above pre-industrial levels. We are consequently witnessing an uptick of extreme weather events even on home soil.

6 OneTrust (2022, 3 November). IFRS Announce International Sustainability Standards Board (ISSB). OneTrust. (https://www.onetrust.com/blog/ifrs-announce-international-sustainability-standards-board-issb/)

7 Envoria (2022) EU Taxonomy Overview. Envoria. (https://eu-taxonomy.info/info/eu-taxonomy-overview)

8 Scholer, Marie and Cuesta Barbera, Lazaro (Date Unknown). The EU Sustainable Finance Taxonomy from the perspective of the insurance and reinsurance sector. European Insurance and Occupational Pensions Authority. (https://www.eiopa.europa.eu/document-library/thematic-article/eu-sustainable-finance-taxonomy-perspective-of insurance-and_en?source=search)

9 National Treasury Republic of South Africa (2022, April). South African Green Finance Taxonomy: First Addition, March 2022. National Treasury: Republic of South Africa. (http://www.treasury.gov.za/comm_media/press/2022 SA%20Green%20Finance%20Taxonomy%20-%201st%20Edition.pdf)

With an extremely vulnerable population here in South Africa, it is important that players in the financial services industry act responsibly and understand the contribution they can make to slow down emissions, and meet our Net Zero targets by 2050.

In order to do this, we require clear guardrails set in place by regulators. This includes integrating environmental risk into supervisory frameworks and deepening climate scenario analysis.

Insurers should also familiarise themselves with South Africa's Green Finance Taxonomy and understand what should and should not be classified as a "green" product under this framework. Finally, the ISSB standards provide a practical reporting baseline to present consistent and comparable information. Whilst still in draft, these standards align reporting principles, structure, and measurement, which are important to form a global reporting baseline that all companies can adopt.

Across risk, reporting and classification, we are gradually heading towards a common reporting language. The global collaboration we have seen across the public, private and government sectors to construct these frameworks is encouraging.

KPMG recently provided its response to the ISSB standards in this article.[10]

[10] https://home.kpmg/xx/en/home/insights/2022/07/sustainability-reporting-ifrs-s1-s2-comment-letter.html