CDSB Climate Disclosure Standards Board

Topic briefing:

Risk disclosure under the EU Non-Financial Reporting Directive

Download the report:
www.cdsb.net/fallingshort

Climate Disclosure Standards Board

Topic briefing: Risk disclosure under the EU Non-Financial Reporting Directive

In May 2020 CDSB published its review of 2019 environmental and climate-related disclosures of Europe's 50 largest listed companies under the EU Non-Financial Reporting Directive (NFRD also referred to as 'the Directive').[1] Overall, we found that substantive improvements are still required in the quality, comparability and coherence of disclosures in order for the Directive to achieve its objective of providing investors and wider stakeholders with relevant, consistent and decision-useful disclosures.

As part of the review, CDSB considered progress made in the disclosure of environmental and climate-related risks by Europe's largest companies. This topic briefing summarises the findings and recommendations of the review with respect to risk disclosure.

Risk disclosure under the EU Non-Financial Reporting Directive

The NFRD requires companies to disclose "*the principal risks related to those matters linked to the undertaking's operations including, where relevant and proportionate, its business relationships, products or services which are likely to cause adverse impacts in those areas, and how the undertaking manages those risks.*"[2] The environmental and climate-related risks disclosed should consider the potential implications for the company in relation to operations, supply chain, financial performance, or ability to achieve strategic objectives.

Risk perspectives

There are two perspectives on risks disclosure, and it is fundamental to understand which one is being considered and disclosed. There is a clear distinction between risks and impacts 'to' the business which differs from the risks and impacts 'by' the business. Under the current Directive, companies are expected to consider and disclose both perspectives, where relevant and proportionate.

As important as the description of the risks, there is an expectation that disclosures include a description of risk management processes. This should include the processes used to identify, manage, and mitigate these risks so as to demonstrate how the significance of risk is established and managed. Both risk perspectives require differing internal processes and, where appropriate, the disclosure should distinguish between where these risks are incorporated into enterprise risk management processes and where a separate process is used.

Connection to the TCFD

Released in 2017, the Task Force on Climate-related Financial Disclosures (TCFD) published a set of recommendations designed to solicit decision-useful, forward-looking information on the material financial impacts of climate-related risks and opportunities. There are clear links and synergies in both the subject matter and reporting requirements between the NFRD and TCFD recommendations, in particular in reference to the disclosure of risks. In 2019, the European Commission published additional non-binding guidelines on reporting climate-related information under the NFRD[3], integrating the TCFD recommendations and demonstrating how climate-related risks can be disclosed under the NFRD.

[1] CDSB (2020) Falling Short? Why environmental and climate-related disclosures under the EU Non-Financial Reporting Directive must improve [PDF]. Available from: https://www.cdsb.net/falling-short

[2] European Parliament and Council (2014) Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups [Online]. Available from: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095

[3] European Commission (2019) Communication from the Commission – Guidelines on non-financial reporting: Supplement on reporting climate-related information (C/2019/4490). [Online]. Available from: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52019XC0620(01)

T: +44 (0) 203 818 3939
www.cdsb.net

Climate Disclosure Standards Board
c/o CDP, WeWork Sony Center
Kemperplatz 1, 10785 Berlin
Germany

Climate Disclosure Standards Board

The current state of play

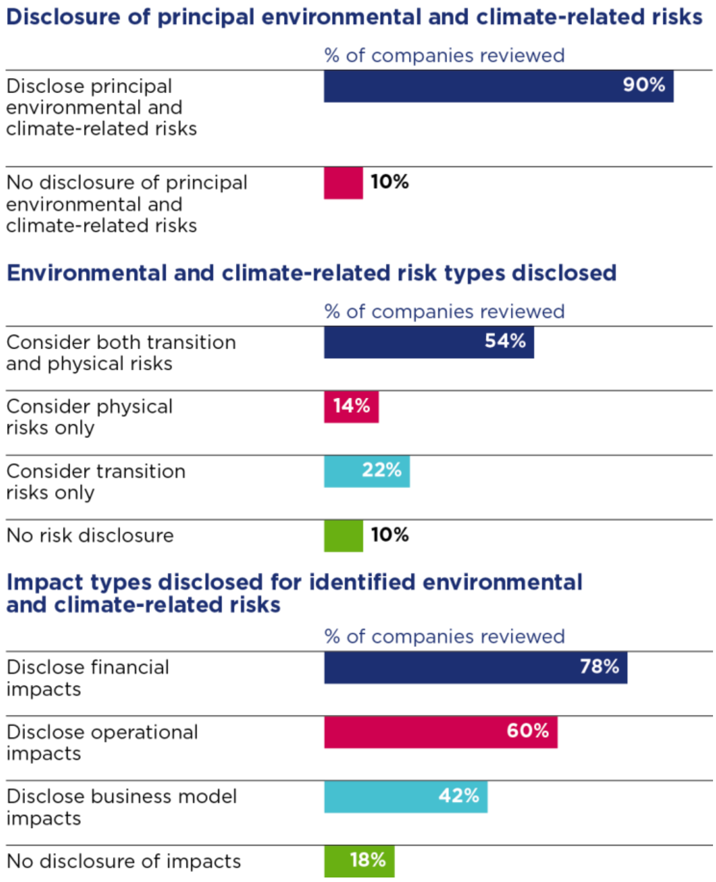
Across the sample, the review found that of the five core content categories of the NFRD, disclosures on principal risk were generally the weakest. Although the majority of companies disclosed at least one principal risk relating to climate or environmental matters, the level of description of these risks varied substantively. A particular weakness was that only 6% defined the short, medium and long-term time horizons over which the identified risks would materialise and impact the organisation. The description of the impacts of risk remains mostly generic, with many companies failing to adequately disclose the strategic and financial impacts of risks to their business. Overall, risk disclosures represent a key area for improvement in disclosure under the NFRD.

Progress of disclosure

Although 90% of companies disclosed at least one principal risk relating to climate or environmental matters, with 54% considering both transition and physical risks, the description of these risks varied. Some disclosures provided a list of climate and environmental risks, with little detail about the nature, context and impact of the identified risks. Similarly, the description of the impact of risks were often generic and lacked entity or context-specific information or quantification.

In relation to the management of risks, 70% of disclosures described the management actions undertaken to mitigate environmental and climate-related risks. Effective disclosures presented the management actions alongside the description of risks and impacts. Further, strong disclosures ensured linkage back to disclosures on policies, due diligence and outcomes. This helped to ensure connectivity, evidencing how risk management informed the development of the company's policies.

Some disclosures demonstrated confusion over whether the Directive required non-financial risk disclosures in addition to existing principal risk disclosures. This was evidenced through additional standalone disclosures of 'non-material' risks where no principal environment and climate-related risks were identified. These standalone disclosures of immaterial risk are potentially misleading and do not support improved decision-making.



Source: CDSB (2020) Falling Short? Why environmental and climate-related disclosures under the EU Non-Financial Reporting Directive must improve

In addition, 28% of companies did not disclose how environmental and climate-related risks are integrated into overall risk management, as recommended in the Directive's climate-related guidelines and by the TCFD. Without clearly articulating how environmental and climate-related risks are integrated into wider business processes, investors are unable to discern how these risks are used to inform companies' decision-making and how significant they are considered to be, relative to other business risks.

T: +44 (0) 203 818 3939
www.cdsb.net

Climate Disclosure Standards Board
c/o CDP, WeWork Sony Center
Kemperplatz 1, 10785 Berlin
Germany

Climate Disclosure Standards Board

Recommendations

Our analysis shows that current principal risk disclosure by EU companies requires improvement. To address the gaps and enhance the principal risk disclosure under the NFRD, CDSB proposes a series of recommendations for companies and for policymakers.

Recommendations for companies

1. **Provide business-specific examples of how identified risks may impact the organisation's operations, business model and financial performance as applicable**

   Companies should provide entity or context-specific descriptions of the impacts of the risks to the organisation, which may include detailed narrative or quantification of the impacts;

2. **Clearly state the time horizons over which risks have been considered and ensure risk descriptions state the likely impacts over the short, medium and long-term**

   To enhance risk disclosure, companies should provide the time horizons used in risk management process, including when the risks are likely to materialise, in alignment with the TCFD; and

3. **Link risks and their management to environmental and climate-related policies, due diligence and outcomes**

   Applying the concept of connectivity helps to demonstrate how risks inform strategic decision-making and provides a holistic picture of the factors and relationships that may affect a company's ability to create value.

Recommendations for policymakers

1. **Remove the exemption allowing the non-financial statement to be reported outside the mainstream report**

   This will support accessibility, consistency and comparability of disclosures and is aligned to the TCFD recommendations, which call for disclosure of material climate-related information in mainstream report, including risks and opportunities;

2. **Review the principal risk requirements of the Directive to ensure emphasis is placed on risks and impacts 'to' the business (not only 'by' the business)**

   This will ensure the risk lens set out under the TCFD is actively considered by companies, in addition to their existing disclosures on risks to the environment, which are more commonly disclosed already;

3. **Member States should consider the interface between the NFRD's requirements and existing national risk disclosure requirements to support companies in making cohesive disclosures.**

   This will help companies make cohesive disclosures on risk, and ensure there is less confusion about the reporting requirements of various reporting regulations; and

4. **Embed the TCFD recommendations into the Directive**

   Their current inclusion within non-binding guidelines is insufficient to drive full adoption of the recommendations. Directly incorporating TCFD into the mandatory requirements will drive stronger linkage of non-financial and financial reporting and is the best means of ensuring climate risk disclosure.

T: +44 (0) 203 818 3939
www.cdsb.net

Climate Disclosure Standards Board
c/o CDP, WeWork Sony Center
Kemperplatz 1, 10785 Berlin
Germany

Climate Disclosure Standards Board

With the contribution of the LIFE Programme of the European Union
Hosted by CDP Europe

T: +44 (0) 203 818 3939
www.cdsb.net

Climate Disclosure Standards Board
c/o CDP, WeWork Sony Center
Kemperplatz 1, 10785 Berlin
Germany