May 1, 2016

IIF Response to
Phase I Report of the
Task Force on Climate-Related Financial Disclosures

Introduction

The Institute of International Finance ("IIF") has long supported improving financial disclosures as part of the overall response to the global financial crisis, and participated on behalf of members in the work of the Enhanced Disclosure Task Force ("EDTF"), the Recommendations of which are making an important contribution to the enhancement of market understanding of banks' risk management, and hence to overall market discipline in the more robust financial environment that banks and public-sector institutions alike wish to foster. The work of the Task Force on Climate-Related Financial Disclosures ("Task Force") takes the FSB's vision of more robust markets further, by providing a framework for useful and comparable voluntary disclosures by private-sector issuers on the risks they may face from climate change.

These very general remarks[1] have been prepared by the IIF staff, in consultation with member financial institutions, to provide overall reactions and to express the interest of IIF members in dialogue during the Task Force's work on its second-phase report and the more detailed recommendations it will contain. The EDTF model should help issuers provide more useful, consistent, and comparable disclosures, while recognizing the complexity of the task of convergence of good practice out of the extensive commentary available, the myriad considerations that may be relevant to different business models, appropriate variations of approach by different businesses and, above all, the ongoing development of users' perceptions of their needs. The job of the Task Force is in some respects more complicated than that of the EDTF, in that the scope of issues about bank risk were relatively well defined, whereas the Task Force has to deal with a wider and perhaps more diffuse range of needs and issues in developing its recommendations to apply to reporting of climate-related financial information, which is a relatively new and evolving are of disclosure.

The Institute's members are financial institutions (banks, insurance companies, and asset management firms) that will be affected by the Task Force's recommendations both as issuers and as users of disclosures by other issuers. Financial institutions are concerned as lenders, investors, underwriters, and market-makers for all descriptions of issuers facing climate issues. As such, they have a high stake in more consistent and accurate distribution and pricing of risks, which the Task Force aims to foster.

Further, the Institute applauds the Task Force's intent to balance the costs and benefits of disclosure, and to consider how to incorporate the principle of materiality into its recommendations. Focus on these considerations will be essential in producing recommendations that will meet the needs of users in a way that achieves efficient and effective disclosure. This is especially the case as the Task Force also wishes to develop forward-looking financial disclosures, which will require extensive management judgment and risk modeling, requiring significant scenario choices, assumptions, and projections with respect to both the risks and the opportunities created by projected climate change.

Balancing of such factors is of course not easy and the Institute and its members are eager to participate in the necessary dialogue. Further, the Task Force's goal of creating a coherent framework that promotes

[1] Because of the very short consultation period and the press of a number of other official-sector consultations during the same period, the IIF will not attempt to answer all 22 of the set questions set out in Appendix 5.

alignment across disclosure regimes and clarifies what constitutes material and relevant risks to investors and to the overall economy will require extensive analysis and inputs from many viewpoints. Again, the Institute is eager to participate in what may be an ongoing dialogue. It may be advisable for the Phase 2 recommendations to be couched as interim or initial recommendations, to be reviewed for effectiveness and efficiency after a suitable period.

General Comments

The Task Force has done a very good job in the first three sections of the Phase I Report of analyzing in general terms the suite of climate risks and opportunities that are now apparent and are likely to evolve and develop over time. This analysis and the related literature review will help issuers to deepen and widen their thinking about climate issues that they might need to disclose. Similarly, users of all descriptions will benefit by guidance to issuers as to how to achieve comparable and consistent disclosures, while still making sure they make the disclosures that are necessary to understanding their idiosyncratic business models.

The Task Force is right to foresee both quantitative and qualitative disclosures. A risk in this kind of exercise is to define quantitative measures so prescriptively that they become rigid and stereotyped, potentially generating apparent but misleading consistency. Although this means that care must be taken in defining quantitative measures, especially where expressed in templates or other formulaic requirements, qualitative commentary on quantitative disclosures will be needed in many cases to give the full picture and avoid misleading extrapolations or conclusions. Investors and other users will need to learn to make equal use of both types of disclosure.

Scenario and sensitivity analysis. Recognition of the need for qualitative discussion and recognition of the forward-looking nature of climate disclosures also suggest that investors, auditors, and securities regulators will need to adjust their expectations in overseeing the kinds of disclosures that will be required. As the Phase 2 Report rightly points out, forward-looking, climate-related disclosures necessarily require consideration of information that is "either not currently knowable or highly uncertain."

In considering to what extent scenario and other sensitivity analyses can be useful, the Task Force should not only consider the good arguments in favor of such analyses advanced at page 27, but it should keep in mind that constructing scenarios and sensitivity analyses can be a complex and costly process, and that multiplying such analyses does not necessarily improve outputs or render disclosures more useful. Rather, the eventual requirements should consider what would constitute judicious selection and use of scenarios or sensitivity analyses, while keeping in mind the principles of materiality and relevance.

In thinking about scenarios and sensitivity analyses, the Task Force would do well to draw upon the debates currently under way on how to achieve the forward-looking analysis required for Expected Credit Loss provisioning under new IFRS and US GAAP standards. The Institute would be happy to facilitate exchanges on those issues.

Governance. The Task Force is right to focus on the need for management discretion in determining relevance, materiality, and appropriate balance in climate-related disclosures. The Task Force already recognizes that its recommendations need to be developed with an eye toward flexibility and minimizing burdens (and that should be read to mean burdens on both issuers and users). As the report states, this will include assessment of board-level responsibilities in making disclosure judgments.

While this attention to governance issues is correct, to yield a balanced result, it should be couched in terms of the already greatly increased burdens and responsibilities on managements' and boards, that have

been imposed, correctly for the most part, since the crisis. Due attention should be paid to the responsibilities of managements and boards, but should be expressed in terms of refinement and focus, rather than additional duties insofar as possible.

Finally, the Phase 2 report should consider in more detail than does the Phase 1 report the liability implications and incentives that may be created around climate disclosures. By their nature, as the report recognizes, climate-related disclosures require extensive use of judgment about matters of great uncertainty, where there will often be wide ranges of possible outcomes. In designing its recommendations for the projected voluntary disclosures, it would be helpful if the Task Force could provide guidance as to reasonable procedures for the exercise of such judgment. It may also find that specific guidance from securities or other regulators would be helpful in creating good incentives to making the necessary forward-looking disclosures, while avoiding the disincentives that uncertainty about possible liabilities will inevitably create. While a good deal of guidance about making forward-looking statements exists, consideration as to whether further guidance on potential areas of liability from the relevant authorities should be undertaken to avoid undue impediments to achieving the Task Force's goals.

Comment on the Principles

The stated principles are entirely appropriate and are easily endorsed. Nevertheless, as the EDTF found, stating recommendations as to the application of the principles, even at a high level, requires a good deal of balancing and discussion to get right.

The following constitutes initial reactions to the bullet points under the current statement of the principles. More consideration and debate will certainly be needed in developing Phase 2.

Principle 1: Disclosures should present relevant information.

The second bullet discusses disclosures of issues that "can have a significant impact on the business model, strategy, risks, or future cash flows" of an issuer. This bullet appropriately refers to the essential materiality principle, but consideration will have to be given to the definition of a "significant impact" in the peculiarly future-oriented context of climate change.

The third bullet, on the fact that impacts can occur over short, medium, and long terms should reinforce the point made above about the need to put appropriate boundaries around liability for the kinds of disclosures that firms may feel are appropriate. Disclosures with respect to medium- and long-term risks in particular need to be made with a sense that disclosures in good faith of possible outcomes can be done without giving financial hostages to fortune if things turn out in the future differently than as imagined today.

Principle 2: Disclosures should be specific and complete

It should be recognized that providing "specific and complete" disclosures of "forward-looking, dynamic" issues inevitably has some built-in contradictory elements and will require judicious balancing to achieve. Indeed, it is hard to see that very forward-looking disclosures could ever be "specific" or "complete" in the literal sense. This principle (if retained in its present wording) should contain discussion of how these terms are to be interpreted in this context

Clarification of "key assumptions" may be appropriate but it should be made clear that such assumptions would not be understood to require disclosure of commercially sensitive information.

It is generally appropriate that "forward-looking quantitative disclosure should align with data used by the company for investment decision-making and risk management"; however, that principle needs a number of caveats. Frist, the judgmental nature of climate disclosures may in some cases imply that a firm should use or refer to a wider range of data than used for its actual decisions and risk management. Business decisions and risk-management assessments may need to make judicious choices and focus on choices once made. Therefore, this principle of tying disclosures to "data used by the company" needs to be understood broadly and flexibly, and not literally. This should not become a liability trap if a firm decides, in good faith, to use somewhat different data sets for different purposes.

Principle 3: Disclosures should be clear, balanced and understandable.

A fair reading of the bullet explanations goes a long way toward explaining the trade-offs between clarity and completeness, sophistication and understandability that firms will face. It is fine to call for "straightforward explanations of more complex issues", for example, but that will not necessarily be easy to achieve. The final recommendations should recognize the difficulty of the task set to issuers by this principle, and perhaps offer some examples of what good-faith efforts would look like.

Similarly, it is of course right that the risks as well as the opportunities should be "portrayed in a manner that is free from bias"; however, freedom from bias is very difficult to demonstrate; the term "bias" has several meanings (statistical bias vs. bias arising from official statistics or other sources beyond a firm's control vs. deliberate bias toward a desired outcome). These contextual issues should be explicated further in defining what is meant by the "freedom from bias" goal.

Principle 4: Disclosures should be consistent over time.

The current narrative appropriately points out the problems that will arise, in part on account of the immaturity of the field. The final recommendations should elaborate upon this discussion.

Principle 5: Disclosures should be comparable among companies within a sector, industry, or portfolio.

Again, the goal is incontrovertible but will be hard to achieve in practice. Much will depend here on judicious balancing in the final recommendations of the level of granularity demanded vs. the need for flexibility and, as stated above, the need to avoid easy but ultimately misleading comparisons. Furthermore, the judgmental nature of forward-looking information will (and indeed should) mean that different issuers may take somewhat different views of what is important or what scenarios to present, which will affect comparability. Achieving this principle will require a good deal of close debate on specific proposals in order to make the outcomes useful and meaningful (as was achieved in the EDTF process).

Principle 6: Disclosures should be reliable, verifiable, and objective.

As discussed above, the question of how freedom from bias is to be understood will be crucial

It is certainly true that disclosures should as far as possible be based on "objective data", but projections are different from data and the difference must be acknowledged. Furthermore, it is not obvious that every firm should have to use "best-in-class measurement methodologies" that may be proposed along the way. What is "best" will not often be so obvious, and there may be some benefit of reducing group-think in following current trends by allowing different firms to develop their own approaches. Common industry practice should and will evolve and should be an important point of reference, but it would mean building in a good deal of bias and potential model risk if every issuer had to use the same "best" measurement methodologies or practices. A given firm may have a different complex of risks, or it may

have earlier insights because of its business model into future risks or opportunities. This is not an area where very granular specification of what is "best" is likely to yield the best possible results for the market overall over time.

While it is important that disclosed information be documented is such a way that the *procedures* used to produce it are knowable and verifiable, verification should not imply overriding management's reasonable judgments or imposing "best" practices or views external to the firm's analysis, where it can show that such analysis was performed in a reasonable and appropriate way under the forthcoming recommendations.

The present explanation of principle 6 veers too far in the direction of prescription and should be reconsidered.

Principle 7: Disclosures should be provided on a timely basis.

Timeliness is important, but it should be defined in such a way as to be consistent with, and not disruptive of, the already complex task firms face in making their required financial and risk disclosures.

Finally, the report is right to recognize that there will inevitably be tensions or conflicts in application of the principles (and the recommendations to come). The only comment here is that this issue should be recognized prominently and up-front in the final document

Conclusion

The forgoing preliminary observations are offered as a very small down payment on the discussion that needs to be had to flesh out the principles into meaningful recommendations that will help firms achieve the Task Force's goals. The Phase 1 report constitutes an excellent foundation for a truly effective and efficient set of recommendations.

The Institute would be pleased to contribute in any way possible to the development of the Phase 2 report and would be particularly interested in working with the Task Force in the Governance and Financial sector streams, as set out in the Terms of Reference for Phase III.

To follow up on any aspect of these comments, please contact David Schraa, Regulatory Counsel, at dschraa@iif.com or +44 207 006 4149.