Risk and Regulatory Outlook 2022

The SEC's proposed climate risk disclosure rules: A call to action for Southeast Asian banks

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The SEC's proposed rules on climate risk disclosures: Consolidated push for action

Overview

On 21 March 2022, the US Securities and Exchange Commission ("the SEC") proposed rule changes that will require registrants to disclose climate risk information in their registration statements and periodic reports[1].

These disclosures include information about climate-related physical and transition risks and opportunities that are expected to have material impact to their business, and includes certain climate-related financial statement metrics on consolidated financial statements.

For example, information related to how an internal carbon price is set (where applicable), how the firm will be affected by the manifestation of physical risks from severe weather events or natural conditions, and the implications of transition activities.

Furthermore, the reporting of greenhouse gas (GHG) emissions targets, Scope 1 and Scope 2 greenhouse gas (GHG) emissions are also required. Reporting of Scope 3 emissions is also required if a registrant has publicly set climate targets or where Scope 3 emissions are material.

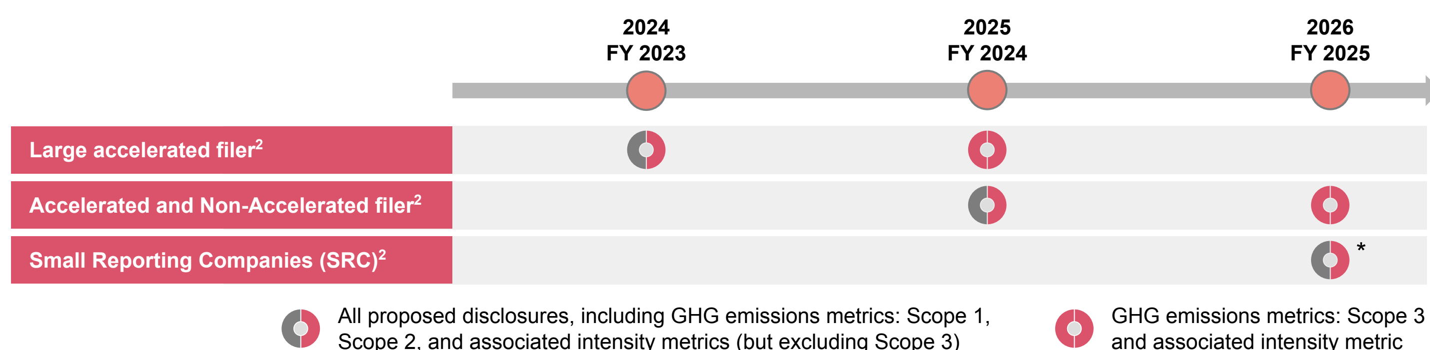
The SEC's proposed disclosure rules have similarities with the Task Force on Climate-Related Disclosures (TCFD)'s framework that covers four core components of Governance, Strategy, Risk Management, Metrics and Targets. Proposed rules and guidance surrounding GHG emissions disclosure are largely consistent with the GHG Protocol's standards, except where the SEC would require a firm to set organisational boundaries to be the same scope of entities under the same accounting principles used in its consolidated financial statements.

Elaboration on how climate-related risks have been assessed and their impacts forecasted towards a firm's outlook and business strategy, are proposed to be shown in the form of the management discussion and analysis (MD&A) section of related filings and in relevant financial statement line items.

The proposed rules would be applicable to all registrants that file with the SEC; they can be regarded as a reference for banks in Southeast Asia as regulators in the region begin to mull over climate risk disclosure rules of their own. This article provides a quick overview of the phase-in timelines, proposed requirements related to risk management-related disclosures and climate-related financial statement metrics, and implications for banks in Southeast Asia.

Phase-in periods and compliance timeline

The SEC is proposing a phase-in period for a smooth transition for (a) large accelerated filers, (b) accelerated filers and non-accelerated filers and (c) smaller reporting companies (SRCs). A separate timeline for Scope 3 GHG emissions is envisioned given the complexity of Scope 3 emissions.



The SEC would provide companies with sufficient time to transit into reasonable assurance, where the expectation of:

- Limited assurance will take place 1 year from compliance date
- Reasonable assurance will take place 2 years from compliance date

**SRCs would be exempted from Scope 3 emissions disclosure in light of the proportionately higher cost they could incur.*

1. US Securities and Exchange Commission, "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors", March 2022
2. US Securities and Exchange Commission, " Accelerated Filer and Large Accelerated Filer Definitions", 2020

1 Risk management

Risk factor disclosure has been paramount in the SEC's disclosure requirements and the proposed rule enhances existing disclosure requirements with the inclusion of climate-related risks.

The proposed rule aims to allow investors a better assessment of climate-related risks as part of the regular risk management processes to make better informed investment or voting decisions. This includes understanding a firm's transition plan on its management of climate-related risks, board and executive's planned response to climate risks, and the commitments made under the Paris Agreement to reduce its GHG emissions. The additional visibility of the registrant's ability to achieve short, medium, or long-term climate-related targets or goals would be important. The following are key components of the SEC's proposed disclosure requirements surrounding climate-related risk management:

- **Processes of identifying, assessing, and managing climate-related risks and their integration into the registrant's overall risk management system or processes**

  When evaluating the overall risk management systems or processes, registrants have to ensure that climate-related risks are considered and whether potential climate policies or weather events arising from climate change would impact business outlook. For each of the climate-related risks, registrants have to carefully consider whether to mitigate, accept or adapt a particular risk, to ensure that there would be quick response over material climate-related risks.

- **Transition plan to include registrants' strategy and implementation plan to reduce climate-related risks, specifically physical and transition risks**

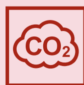
  The proposed rules define a "transition plan" to mean a registrant's strategy and implementation plan to reduce climate-related risks. This includes a GHG emissions reduction plan in line with commitments within jurisdictions where a firm has significant operations, and the relevant metrics and targets used to identify and manage physical and transition risks. Forward-looking statements made as part of a registrant's discussion of its transition plan would fall under the safe harbour provisions under the applicable conditions.

- **Required disclosures for physical and transition risks and risk management requirements**

  The proposed rule would require a registrant to specify whether an identified climate-related risk is a physical or transition risk and to disclose the risk management process for any identified climate-related risks. For all material risks, the transition plan disclosed should cover mitigation or adaptation initiatives.

Physical Risk

Physical risk disclosure entails a description of the risk nature (e.g., exposure to sea level rise, extreme weather events, wildfires, drought, severe heat) and whether it is considered as an acute or chronic risk. Where an asset or operational process is identified to be vulnerable to physical risks, its location and the likely material impact on the business or consolidated financial statements has to be disclosed.



Transition Risk

Transition risk disclosures require a description of its nature (whether it is regulatory, technological, market (including changing consumer, business counterparty, and investor preferences), liability, reputational, or other transition-related factors) and how these factors impact the registrant.

- **Identification of climate-related risks and opportunities**

  Registrants have to identify actual or potential positive impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operations, or value chains, as a whole.

2 Climate-related financial statement metrics

In addition to disclosures surrounding strategy, business outlook, and risk management, the SEC's proposed rules would also mandate the inclusion of certain financial impact and expenditure metrics arising from climate-related risks.

Information about the impact of climate-related weather conditions, transition activities is expected to be displayed in a disaggregated format, unless the aggregated absolute value of the impact across physical and transition risks is less than 1% of the total line item value for the fiscal year.

- **Financial impact metrics covering revenue, costs, cashflows:**

  The emphasis here is the manifestation of impacts of climate-related events that would impact the revenues, costs, changes in loss reserves or provisions, or changes in operating, financing, investing cash flows.

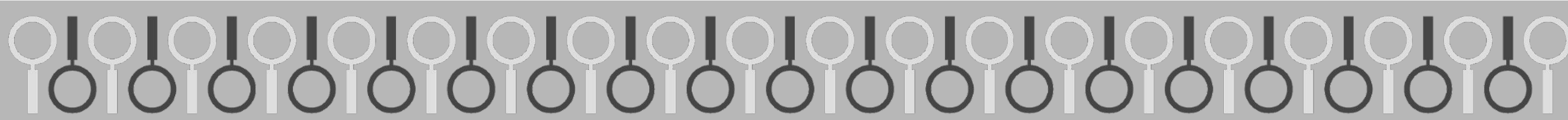
  The SEC cited examples that included a negative impact to cost of revenue from disrupted supply chains due to bad weather for a manufacturer, changes to loss provisions arising from severe weather events that would be relevant to insurers, losses in revenue from new GHG emissions pricing or climate rules that result in non-viability of certain products. On the other hand, reduced cost of goods sold from technology changes that protect raw materials from severe heat or more energy efficient methods in the production process are also cited.

  Another line item impacted would be changes to the carrying amounts or impairment costs of assets due to exposure to physical risks or reduction in useful life due to transition risks.

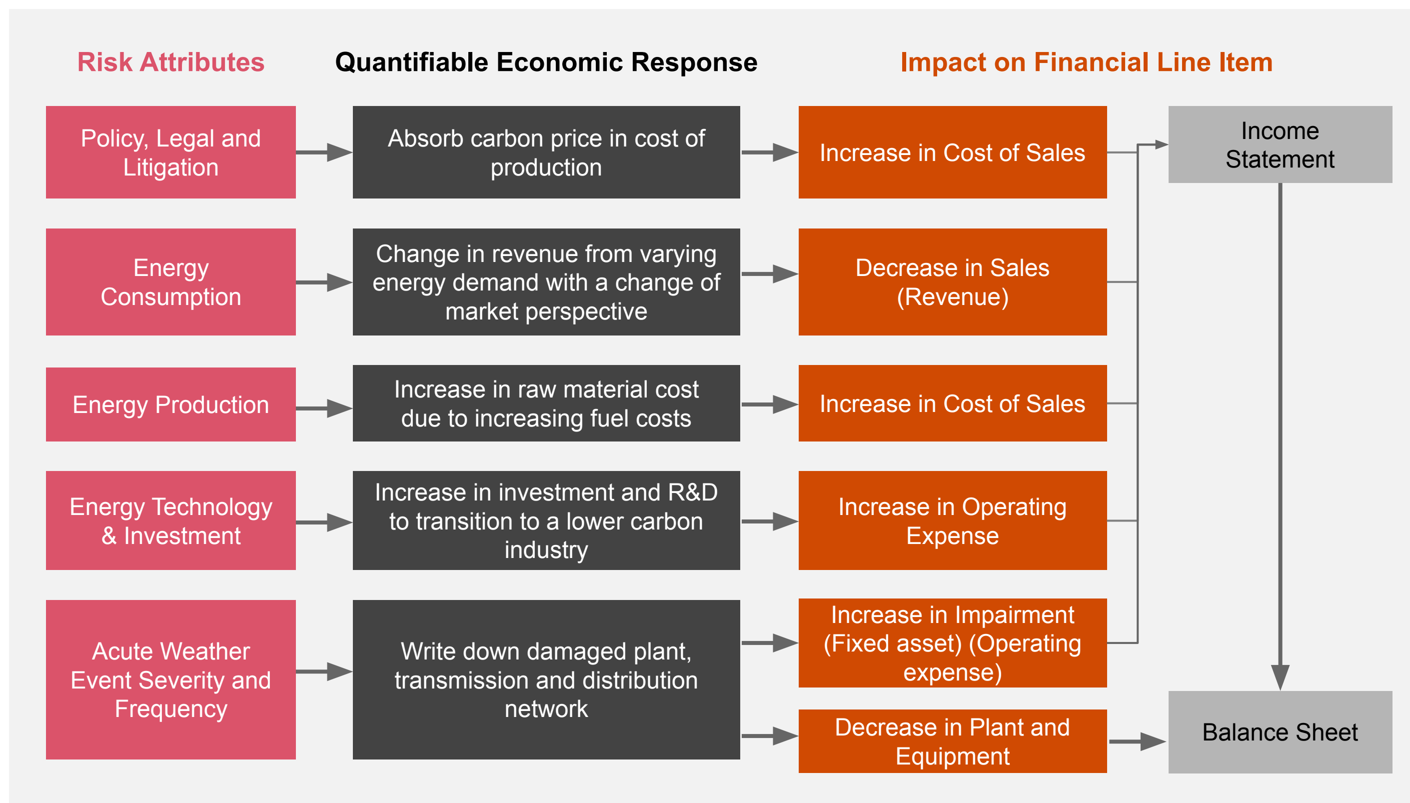
- **Expenditure metrics covering expenditure expense on income statement and capitalised costs on balance sheet**

  Firms are required to separately present amounts of (i) expenditure expensed and (ii) capitalised costs incurred in their management of climate-related risks. This would involve separate disclosure of the amounts incurred towards dealing with the physical risks and transition risks.

  For physical risks, this would refer to the costs incurred to increase business resilience or mitigating the potential impacts of severe weather events, such as relocating operations or facilities in vulnerable locations or the shortening of useful lives of impacted assets. Examples of transition risks-related costs include the costs of energy credits to offset emissions, the purchase or development of technologies or assets that reduce GHG emissions and improve resource efficiency etc.



Illustrative example of transmission channel for a utility company:



3 Disclosure of GHG emissions

The proposed rules would also mandate the disclosure of Scope 1 and Scope 2 GHG emissions where in-scope GHG are those covered under the Kyoto Protocol and the United Nations Framework Convention on Climate Change (UNFCCC).

Scope 1 emissions refer to direct emissions from owned or controlled sources whereas Scope 2 emissions are indirect emissions arising from purchased electricity. The SEC proposes that firms use measurement methodologies and emission factors to convert GHG amounts into carbon dioxide equivalent (CO2e) units that are aligned with guidance from the GHG Protocol for consistency with the leading framework.

Under the proposed rules, Scope 3 emissions which consist of all indirect upstream and downstream emissions that arise from the value chain of a firm are to be disclosed if material or if the firm has publicly set climate targets. The determination of materiality of Scope 3 emissions, or if Scope 3 emissions are identified to be a significant source of risk, requires prior measurement. Through the determination process, firms may well consider to disclose Scope 3 emissions and include it as part of their data and reporting strategy.

The GHG emissions data should be presented separately by GHG type and in aggregate on absolute terms, i.e., without offsets from carbon credits or renewable energy certificates.

Another proposed requirement is to present emissions data in the form of an intensity ratio, i.e., emissions in terms of metric tons of CO2e per unit revenue or per unit of economic output for the fiscal year. This implies that GHG intensity can be seen as a proxy for resource efficiency or degree to which a company is a polluter. This proposed metric could invite scrutiny on the extent to which a firm is exposed to transition risks and climate-related regulation.

Implications for Southeast Asian banks

While the proposed SEC disclosure rules are applicable across the board to filers to the US exchanges, it represents a concerted push from another key global regulator that will influence the pace and degree to which banks in Southeast Asia have to integrate ESG strategies and related milestones into their overall strategy.

Reporting complexity can increase for entities that have to report under the European Union's Sustainable Finance Disclosures Regulation (SFDR), locally mandated disclosures, and existing accounting practices.

The proposed disclosure rules aims to mandate a clear identification of climate-related risks and opportunities, express (therefore setting a strategic prerequisite for) the impact of climate-related issues on a firm's business outlook, measure GHG emissions, and translate all of these through to financial impacts to the bottom line.

While the proposed rules are largely aligned with the TCFD framework and GHG Protocol's principles thus reducing the implementation burden to an extent, banks are faced with the unique challenges of:

- **Calculating financed and Scope 3 GHG emissions:** Given that Scope 3 emissions are expected to be material to a bank's value chain, it is likely that banks will have to disclose their Scope 3 GHG emissions. As the emissions arising from banking products will fall as part of a bank's value chain, banks should be proactively considering approaches towards achieving broad coverage of Scope 3 emissions, both by engaging with obligors directly to obtain data and sourcing external data providers.

- **Data scarcity in wholesale and SME portfolios:** As part of tallying Scope 3 emissions and calculating GHG intensity, banks would be required to extend data exercises to these portfolios where obligors may not have achieved the sophistication required to measure their own GHG emissions or considered their adaptation strategies in a circular economy. This may be a bigger challenge in Southeast Asian economies with a larger proportion of SME industries where the awareness of ESG topics is still developing. Nevertheless, banks should be pursuing other avenues to assess these smaller obligors through a top-down sectoral approach in parallel to engaging obligors directly.

- **Aligning product policies and limits to climate targets and strategy:** For Southeast Asian-incorporated banks who may be SEC registrants or filers, ESG reporting requirements mean that climate or sustainability strategies need to be coherently implemented through front office and risk functions such that the disclosures present a consistent house view.

Implications for Southeast Asian banks (cont'd)

- **Building or acquiring regional climate data coverage:** The availability of historical and forecasted climate data for Southeast Asia remains less mature compared to other regions. Banks should begin to source quality data whether from government agencies or international databases (for instance, the Network for Greening the Financial System (NGFS) Climate Scenarios database) and ensure that Southeast Asia's unique geographical and climate context is considered. Relevant physical risks for the region would include typhoons, storms, floods, sea level rise, and water stress.
- **Modelling financial statement line item impact for bank's own reporting and for credit risk modelling:** Taking a page from the proposed rules where the climate impact on financial statement and expenditure metrics has to be disclosed in a disaggregated way, banks' risk models should articulate transmission channels to both evaluate the climate risks faced by obligors through credit reviews and loss forecasts for provisions. Data structures should ideally be sufficiently granular (potentially to the line item level) to support both aggregated and disaggregated reporting and be linked to the chart of accounts for financial reporting.
- **Responding to multiple related requirements in the same window:** ESG disclosures, climate risk management, and green taxonomies are complementary themes that banks are expected to address over the following three years. It is crucial to begin early. Implementation plans and regulatory engagement should be at the forefront of ESG regulatory strategy.

Operational considerations

Here are several practical steps that banks can take to prepare for ESG disclosure requirements and build KPIs or change programmes around the topic:

- Understand detailed requirements applicable to the entity and form a strategy to address specific areas, including assessing current exposures and establishing a data pipeline that enables views of existing portfolios.
- Accelerate their response by identifying core capabilities needed (e.g., sustainable finance and reporting) and niche areas that require external advisory support (e.g., climate research, environmental policy experts) and begin to engage accordingly.
- Begin to tally their own Scope 1, 2, and 3 GHG emissions including financed emissions by engaging obligors across the board to provide the necessary data inputs. This will include building awareness amongst smaller obligors newer to the ESG agenda.
- Link and integrate climate-related risk into risk inventories and integrate the climate angle into business decisioning and risk management processes.
- Starting with qualitative assessments, build flexible dashboards and tools that can handle multiple reporting requirements to assess climate-related risk factors on a proactive basis to facilitate risk identification and monitoring for disclosure.
- Enhance reporting infrastructure to incorporate additional granularity and disclosures related to climate and sustainability risks.

Conclusion

As more regulators across different jurisdictions begin to mandate climate-related disclosures, banks and other firms will face challenges in incorporating what has previously been considered an externality consideration into data and risk frameworks, business strategies, and quantifying climate impact accordingly.

Building the relevant tools, data sources and expertise to consider climate-related impact on financial statements will be an important task for banks as the industry leans into its role as a key driver towards building a sustainable economy.

"Sustainability and climate-related disclosure is the outcome of an end-to-end sustainability strategy executed through an organisation. Climate impact is no longer an externality that can be ignored."

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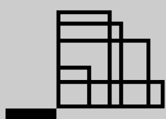

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