Coversheet: Climate-related Financial Disclosures

Advising agencies	Ministry of Business, Innovation and Employment and Ministry for the Environment
Decision sought	23 July 2020
Proposing Ministers	Hon James Shaw , Minister for Climate Change and Hon Kris Faafoi, Minister of Commerce and Consumer Affairs

Summary: Problem and Proposed Approach

Problem Definition

What problem or opportunity does this proposal seek to address? Why is Government intervention required?

Many businesses today face significant physical and transitional risks (and potentially opportunities) relating to climate change. However, few are aware of, or are providing information to investors about how climate change may impact their businesses strategies and financial position.

This information barrier is driving what the Productivity Commission termed "an ongoing and systemic overvaluation of emissions-intensive activities", resulting in poor medium- to long-term decision making, mispricing of assets and the misallocation of capital. This in turn creates macro-economic financial stability risks and creates barriers to the investment in low-emissions and resilient economic activities needed to meet New Zealand's 2050 zero carbon target.

Addressing these information gaps through better risk identification and disclosure can help businesses and investors make more informed and efficient decisions. While tools exist for them to do this now, poor voluntary adoption and inconsistency in application suggests that Government intervention is required.

Summary of Preferred Option or Conclusion (if no preferred option)

How will the agency's preferred approach work to bring about the desired change? Why is this the preferred option? Why is it feasible? Is the preferred approach likely to be reflected in the Cabinet paper?

The preferred option is to introduce a mandatory (comply-or-explain) climate-related financial disclosures system for Financial Market Conduct Act 2013 (FMC Act) reporting entities, based on standards issued by the External Reporting Board (XRB) under the Financial Reporting Act 2013. This will seek to reveal:

- how financial market participants identify and manage climate-related financial impacts
- their approach to governance of those impacts
- what strategies they have in place
- what metrics and targets the organisation uses to measure impact and progress.

Mandating disclosure of climate-related financial risks and opportunities requires businesses operating within the financial markets to consider what climate change might mean for them.

Setting a single reporting framework will allow investors to make more informed decisions across comparable datasets, and more accurate information provision will contribute to realigning the financial valuation of emissions intensive and non-resilient activities. This proposal will therefore contribute to the more efficient operation of financial markets.

Section B: Summary Impacts: Benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?

The primary purpose of this proposed intervention is to promote the efficient operation of financial markets through greater transparency and more information. The primary beneficiaries are therefore actors within the financial markets, from businesses seeking capital, to institutional and retail investors who are seeking returns. Benefits may include better access to capital and more accurate risk valuation.

We anticipate a monetised benefit for those companies with business strategies, products and services that are demonstrably aligned with the transition to a zero carbon economy. This extends to data service providers, consulting and accounting firms who will likely play an important role in the data gathering, data interpretation, and implementation of this disclosure system.

We expect there will be non-monetised benefits for businesses who make use of this disclosure system as an exercise in medium and long-term business strategy. Businesses who are considering the resilience of their strategies against likely physical and transitional impacts from climate change will benefit from that analysis.

Because of the significant societal impact of decisions made within the financial sector, there are also secondary beneficiaries to this intervention. Although it is not the primary purpose of the intervention, we anticipate that understanding climate-related risks and opportunities within the financial markets will drive investment in resilient and low emissions activities, with wider social benefits including a more stable, lower cost transition towards a low emissions economy.

Where do the costs fall?

Regulated parties

These proposals will be reliant upon the External Reporting Board developing reporting standards. As the standards have not been developed yet, the impacts and related costs for reporting entities have yet to be established.

However, costs for regulated parties are likely to arise from staff time to collect and analyse data to prepare reports, and potentially in hiring consultants for advisory and assurance services.

Rather than introducing new costs we consider that this proposal is bringing forward costs that would have been incurred sooner or later anyway given the direction of travel of reporting and increasing expectations to do this kind of reporting. Marginal monetised costs cannot be quantified with any degree of confidence as there is likely to be a significant range across regulated parties (ie some are already disclosing and some have not yet started to consider climate change impacts) and because there is a lack of quantitative evidence (see section 1.2).

Government or independent government agencies:

The proposals envisage that the XRB and Financial Markets Authority (FMA) will both have significant new functions relating to climate-related financial disclosures, which will require additional funding in both cases. The XRB has estimated it will need $1 million in the first year S9(2)(f)(iv)

In addition to this, the Ministry for the Environment will play a role in providing data sets and scenarios for regulated entities to use in their disclosures. This role may require additional funding from FY21/22.

What are the likely risks and unintended impacts? How significant are they and how will they be minimised or mitigated?

Risks include:

- The economic fallout of COVID-19 means that businesses are likely to be under greater pressure than usual for the next few months. Discussing new business regulation at this point may therefore be seen as adding burden to businesses, when they are focussing on core business issues. However we have not observed any decline in support for this proposal amongst regulated parties during the last few months. This is supported by the XRB hearing greater market demand for integrated reporting standards, including on climate change, as the COVID-19 crisis has revealed the value in having more holistic data to understand the resilience of companies.
- It should be noted that the FMA considers confidence in the new regime will be undermined if it proceeds as currently proposed, because they consider there to be an initial practical impossibility of compliance by managers of registered investment schemes. MfE and MBIE officials do not agree with this assessment, as asset managers internationally are already publishing climate-related financial disclosures. A number of New Zealand-based fund managers are also signatories to the United Nations Principles of Responsible Investment (UN PRI), which is making climate-related financial reporting (governance and strategy) mandatory for signatories from 2020.
- As the current proposals apply to FMA reporting entities and not to private, non-issuer companies, they may be considered an additional barrier to listing on the New Zealand Exchange (NZX). This could lead to smaller market participants relocating offshore or adjusting their operations to avoid this additional regulatory burden and associated compliance costs. This would be detrimental to the depth of New Zealand's capital markets. This fits into a wider context in which industry is already concerned about the depth of the capital markets (see Capital Market 2029). However, we note that:
    - the NZX Code already includes a principle (see recommendation 4.3) that "an issuer should provide non-financial disclosure at least annually, including considering material exposure to environmental, economic and social sustainability risks and other key risks." We therefore consider that obligations of this nature already exist. These proposals will make the obligations more explicit and have the additional benefit of standardising the

disclosures across NZX listed companies, rather than introducing additional burden.

  - There is an international trend towards requiring or expecting disclosure of climate-related financial information in accordance with the Task Force on Climate-related Financial Disclosures recommendations, the same framework we are proposing to follow here.[1] We therefore consider that this will not be seen as a significant barrier to listing in New Zealand in comparison with another similar country.

- Poor data availability, particularly at the listed issuer level, may create a vicious circle of poor quality reporting. As a consequence, the FMA is concerned low quality reporting may create low confidence in the regime's effectiveness, thus reducing the overall volume of reporting. This could be minimised through the provision of greater education, guidance and tools for regulated entities by regulators and MfE which enables those regulated entities to gather more, and higher quality data.

- Where an underlying company doesn't disclose (i.e. as a non-listed issuer, not captured by this regime), that will present further challenges to upstream investors. These investors can communicate with organisations in which they invest or are planning to invest, undertake in-house research, and/or use data providers. Current international best practice involves communication with investees alongside in-house research using public data sources such as the World Bank, the OECD, or company financial reports. This analysis is often supported by information from data providers. This can go some way to mitigating this risk. As climate-related financial disclosure becomes more commonplace, we expect that market pressures will start to affect those non-listed issuers too. We are also proposing to consult further on whether these entities should be required or encourage to disclose this information.

- Some regulated parties may see the regulations as a compliance exercise rather than an exercise with strategic value, undermining the value they receive from undertaking the analysis. This too can be mitigated to some extent through education and provision of best practice case studies by regulators. Although this will be iterative, international good practice handbooks, case studies and guidance are already available for corporates and investors.

- Reporting entities may undertake shallow risk identification exercises, underplaying the extent to which they may impacted by climate change. That could lead to poor capital allocation decisions and undermining confidence in the regulatory regime. This will require market pressure to come to bear, and can also be mitigated in part by the oversight of the FMA.

Overall, the likely risks are anticipated to diminish over time as regulated entities learn by doing, and through greater education and capability building by regulators.

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?
Confident: The policy follows the recommendations from the G20 Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). The TCFD framework is widely

[1] For example, the ASX Corporate Governance Council's Corporate Governance Principles and Recommendations, the UK's Financial Conduct Authority requiring premium listed issuers on the London Stock Exchange to disclose.

regarded as international best practice for climate-related disclosures. In developing its recommendations, the TCFD ran outreach and engagement activities in 43 countries and consulted with climate change experts, academics, NGOs and financial and non-financial companies to develop a consensus-based, industry-led approach.

The Productivity Commission's 2018 *Low-emissions economy* report recommended that the government should endorse the TCFD recommendations and should implement a mandatory (comply-or-explain) principles-based disclosure system.

We have consulted robustly on policy design (see section 2.4).

Key areas of uncertainty relate to costs (see section 1.2) and timing, given the key role of the XRB.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Ministry for the Environment and Ministry of Business, Innovation and Employment
Quality Assurance Assessment:
A joint Regulatory Impact Analysis Panel with members from the Ministry for the Environment and Ministry of Business, Innovation and Employment has reviewed the Regulatory Impact Statement and confirms that the analysis meets the criteria necessary for Ministers to make informed decisions on the proposals in this paper.
Reviewer Comments and Recommendations:

Impact Statement: Climate-related Financial Disclosures

Section 1: General information

1.1 Purpose

The Ministry for the Environment and the Ministry of Business, Innovation and Employment are solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing:

- final decisions to proceed with a policy change to be taken by or on behalf of Cabinet

Many businesses today face significant risks (and potentially opportunities) relating to climate change. By 'climate-related' financial risks, we are referring to physical risks, such as more frequent or severe weather events like flooding, droughts and storm which may cause harm to plant and property; and transition risks that result in rapid repricing of financial assets, arising from shifts in policy or changes to consumer preference and behaviours. The same changes may result in opportunities, such as through new technology development, and the opening up of new markets to meet those changes in consumer preference. Climate risk is not the same as a company's greenhouse gas emissions (although a large volume of emissions may indicate greater risk).

However, few are aware of, or are providing information to investors about how climate change may impact their businesses strategies and financial position. This information barrier is driving what the Productivity Commission termed "an ongoing and systemic overvaluation of emissions-intensive activities", resulting in poor medium- to long-term decision making, mispricing of assets and the misallocation of capital. This in turn creates macro-economic financial stability risks and creates barriers to investment in low-emissions and resilient economic activities need to meet New Zealand's 2050 zero carbon target.

At the same time, achieving the Paris Agreement goal of limiting global temperature increases to 1.5°C above pre-industrial levels will involve a portfolio of mitigation options, including disinvestment in high greenhouse gas (GHG) emitting products, processes and activities, and increased investment in new technologies, energy efficiency and clean energy sources. Financial markets worldwide will make a significant contribution towards achieving these investment outcomes.

Addressing the information gaps around likely climate change impacts through better risk identification and disclosure can help businesses and investors make more informed and efficient decisions that align with the Paris Agreement, and with New Zealand's legislated zero carbon target by 2050.

The key policy decision is a recommendation that:

Most financial market participants as set out in the Financial Markets Conduct (FMC) Act 2013 will be required to annually disclose financially material climate-related risks and opportunities in financial reports. In particular, we intend to capture some large FMC Reporting Entities with higher levels of public accountability (section 461K), namely:

- issuers of equity securities or debt securities under a regulated offer, i.e. a company listing stocks or bonds on the NZX
- managers of registered schemes, such as KiwiSaver schemes, other Superannuation schemes, insurers and investing foundations.
- registered banks,
- licensed insurers, such as health, general, and life insurers
- credit unions
- building societies

Taking a principle of proportionality, this would apply to all banks, and managers of registered schemes with greater than $1 billion in total assets. In addition to using the same $1 billion asset threshold, insurers will be included if their annual premium income is greater than $250 million. These thresholds capture approximately 90% of the financial assets under management in New Zealand. The regime intends to apply to all listed issuers, with no exemption threshold.

Crown financial institutions would additionally be required to disclose through the reporting obligations provisions in the Crown Entities Act 2004.

Disclosures would not be required of private, non-issuer companies or large greenhouse gas emitters unless they are included by one or more of the above categories.

Disclosures would be made on a comply-or-explain basis, against one or more standards developed by the External Reporting Board (XRB). The standards are expected to be developed on the basis of the disclosure framework set out by the Taskforce on Climate-related Financial Disclosures (TCFD). The key recommended disclosures that make up the framework are set out in figure 1, below. The disclosures would focus on the impact that climate change may have on a business, not the impact a business has on climate change (i.e. emissions).

Figure 1: Recommended disclosures which form the TCFD framework.

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organization's governance around climate-related risks and opportunities.	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material.	Disclose how the organization identifies, assesses, and manages climate-related risks.	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material.
Recommended Disclosures	**Recommended Disclosures**	**Recommended Disclosures**	**Recommended Disclosures**
a) Describe the board's oversight of climate-related risks and opportunities.	a) Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term.	a) Describe the organization's processes for identifying and assessing climate-related risks.	a) Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
b) Describe management's role in assessing and managing climate-related risks and opportunities.	b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning.	b) Describe the organization's processes for managing climate-related risks.	b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 greenhouse gas (GHG) emissions, and the related risks.
	c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario.	c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management.	c) Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets.

Examples of TCFD-aligned reporting can be found below:

- Meridian 2019 TCFD report (noting however that this is a standalone report, rather than disclosures integrated into the annual report)
- A range of examples can be found in the SASB and CDP Good Practice Handbook

Taking a comply-or-explain approach enables flexibility for reporting entities. Non-disclosure would be permissible where an entity analyses and reports that they see themselves as not being materially affected by climate change, with an explanation as to why (including details on the assumptions on which their analysis was based). Where there are genuine challenges to disclosing (for example, inability to source data after taking a best endeavours approach) this could also be explained, with a roadmap on how to manage those challenges in the future.

Information disclosed would not need to be assured initially, with the exception of any greenhouse gas emission data, where assurance practice is already mature.

How does this work?

The intervention logic of this regime is that it creates a chain of information across financial markets. For example, an NZX listed company discloses information about how climate change may present risks and opportunities in the short-, medium- and long-term, and how it is mitigating or optimising that, within its annual reports. Banks can then use that information to make lending or ownership decisions, insurers can use it to make underwriting decisions or investment decisions, and fund managers can use it to make asset allocation decisions.

In turn, fund managers will disclose whether and how their funds are exposed to climate change, and how they are mitigating any risks (e.g. through greater stewardship, engagement and voting) to their clients, the end investors. The end investors (e.g. institutional investors, retail investors) are able to use the disclosures to make more informed decisions on which fund managers or banks to give their money to.

The exercise of producing disclosures may additionally prompt companies to make different strategic decisions to improve resilience against climate change.

1.2 Key Limitations or Constraints on Analysis

Limitations of scope

The analysis has been limited by two pre-existing documents: the Productivity Commission's *Low-emissions economy* report (2018), and the Taskforce on Climate-related Financial Disclosures final report (2017).

In 2017, the Minister for Climate Change Issues, Minister of Finance, and Minister of Economic Development asked the Productivity Commission to "identify options for how New Zealand could reduce its greenhouse gas emissions through a transition towards a lower emissions future, while at the same time continuing to grow incomes and wellbeing". In 2018, the incoming Minister for Climate Change signalled a more ambitious agenda

and asked the Commission to include the target of achieving net-zero emissions by 2050 in its analysis.

Productivity Commission's *Low-emissions economy* report & the Government's response

The Productivity Commission released its final report in August 2018. The report included two recommendations related to climate-related financial disclosures:

- the Government should endorse the recommendations of the Taskforce on Climate-related Financial Disclosures as one avenue for disclosure (R7.3)
- the Government should implement a mandatory (on a comply-or-explain basis) principles-based, climate-related financial disclosures by way of a standard under section 17(2)(iii) of the Financial Reporting Act 2013. These disclosures should be audited and accessible to the general public (R7.4).

The Government's response to the Productivity Commission's report, the Climate Action Plan, released August 2019, agreed with R7.3 and agreed to investigate R7.4.

The Ministry for the Environment (MfE) and the Ministry of Business, Innovation and Employment (MBIE) jointly published a discussion document in October 2019, with proposals to give effect to this recommendation.

Task Force on Climate-related Financial Disclosures

In April 2015, the G20 asked the Financial Stability Board to convene public and private sector participants to review how the financial sector could take account of climate-related issues. The Financial Stability Board established the Taskforce on Climate-related Financial Disclosures in December 2015 and asked it to develop voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to investors, lenders, insurance underwriters and other stakeholders (credit rating agencies, equity analysts, stock exchanges, investment consultants, and proxy advisors who also, in principle, depend on the same types of information).

The TCFD framework structured recommendations around four thematic areas that represent the core elements of how organisations operate: governance, strategy, risk management, and metrics and targets. Within the four thematic areas, 11 sets of disclosures were recommended. These recommendations 'aim to be ambitious, but also practical for near-term adoption'.[2]

The TCFD's recommendations are widely regarded as the benchmark for climate-related disclosures. The recommendations create a structure through which companies can better identify, manage and disclose climate-related risks and opportunities. They facilitate a more forward-thinking, strategic approach, as opposed to retrospective data reporting.

This analysis therefore has focussed on the TCFD as a framework on which the XRB should develop climate-related disclosure standards. The XRB will ultimately be responsible for developing the standards in New Zealand.

Constraints on analysis

[2] TCFD. 2017. *Final report: Recommendations of the Task Force on Climate-related Financial Disclosures*

Following regulation, the final disclosure framework will still need to be developed. There are therefore constraints on our analysis in that regard.

Evidence

Our analysis of compliance costs and associated benefits are constrained by a lack of quantitative evidence. In our consultation with a range stakeholders (both through written submissions and bilateral meetings), we received very little information on likely costs. Some stakeholders made the point that they viewed this as an investment rather than a cost, with better disclosure resulting in improved strategies and stronger financial positioning over the longer term, and noting that the cost of inaction is greater than the likely cost of compliance.

Upon further investigation, stakeholders responded that costs are unlikely to be quantifiable as this is as a core part of business risk management. For example, some banks suggested it would be nearly impossible to unpick the cost of complying with this regime from other strategic analysis.

Arguably, assessing climate-related financial risks is already a legal requirement for many organisations through existing obligations, such as directors' duties and the NZX Listing Rules.[3] Our proposals mandate a format for reporting that information and makes the legal requirement explicit, but implies:

- imposing new costs earlier than many entities would otherwise have started incurring them
- reducing costs by standardising the reporting requirements and through the publication of guidance material by government agencies.

It appears the cost range will vary significantly based on the maturity of current strategic analysis processes within a reporting business. As such, upfront costs for first time reporters is likely to be far higher than for those already exploring climate-related risks to their business. Costs are also likely to vary based on the size and nature of the business.

The Government can mitigate some short-term costs by developing clear market guidance, tools and resources to assist in implementation. Greater information sharing across sectors can also help to bring costs down, and costs are likely to decline over time as analysis of this nature becomes more mature, driven by widespread uptake.

Secondary evidence

We have reviewed the UK's Financial Conduct Authority (FCA) analysis on costs to 'premium listed issuers' for undertaking TCFD analysis.

This tentatively estimates a one-off cost per 'medium'-sized issuer of £360,000 (NZ$720,000) and ongoing cost per issuer of £100,000 (NZ$200,000). As UK issuers are generally further ahead with voluntary TCFD reporting than New Zealand businesses they likely have more reliable data, although it cannot be assumed that this can be directly translated to the New Zealand context (note for example that the UK has had mandatory carbon reporting for 7 years, and as of 1 April 2019, all 'Large Companies' under the UK Companies Act 2006 are required to report publicly on their UK energy use and carbon emissions within their Directors' Report, so companies are more accustomed to disclosing non-financial, climate-related information).

[3] See Chapter 3, Ministry for the Environment & Ministry of Business, Innovation & Employment. 2019. Climate-related financial disclosures – Understanding your business risks and opportunities related to climate change: Discussion document. Wellington: Ministry for the Environment.

We understand that these costs assumptions are based on information provided to the FCA by those organisations already doing voluntary analysis. A 'medium'-sized business in the UK context will be larger than what would be termed a medium-sized business in New Zealand. We therefore consider that these costs are of limited value to our cost analysis.

The FCA notes in paragraph 43 of its consultation that 'issuers were unable to quantify the incremental costs that they had [incurred]' and that another similar study was unable to reliably quantify costs of compliance because 'reporting may well be absorbed into day-to-day work and not be identified as a specific cost'. In terms of benefit, the FCA also found it is not reasonably practicable to quantify the benefits of the proposal, as many benefits will be indirect, operating via better market functioning. This is consistent with our primary research.

Further assumptions on costs are discussed in section 5.

Limitations on consultation and testing

It is possible that given the fairly low level of awareness about climate-related financial disclosures, those who engaged with the proposals and voiced support are more likely to be those already exploring climate-related financial disclosures. We note the total number of respondents to the consultation was relatively low, at 77 respondents (noting the regime as proposed would apply to approximately 260 entities).

There is a wider group of businesses and investors who haven't started to consider how climate change will affect their business yet, who likely did not engage with the consultation. However we did contact relevant stakeholders (entities proposed for inclusion in the regime) to inform them of the discussion document and consultation, and ran a webinar to enable as many stakeholders around the country to attend as possible.

A key challenge in our consultation is that we originally proposed that 'asset owners' be in scope. The term 'Asset Owner' is not commonly used in New Zealand financial markets and therefore caused some confusion during the consultation process. We have now addressed this by using the terms 'managers of registered schemes' to provide more clarity.

The MfE-MBIE discussion document did not include any specific reference to iwi businesses. Officials did not see this as necessary, because the proposals relate to the efficient and effective operation of financial markets generally. However, the Iwi Leaders Forum and the Federation of Māori Authorities were both advised of the release of the discussion document via email on the day that it was published. We subsequently discovered that our proposals were insufficiently clear about the non-inclusion of iwi businesses. We have engaged with iwi in the policy development process and clarified this point.

A final limitation on consultation and testing policy proposals was a relatively short timeframe to deliver policy recommendations, compounded by attention being drawn elsewhere for several months during the COVID-19 crisis.

1.3 Responsible Manager (signature and date):
Alex White, Acting Manager Sustainable Finance Ministry for the Environment 13 July 2020

Section 2: Problem definition and objectives

2.1 What is the current state within which action is proposed?

Impact of climate change on financial stability

Climate change is already presenting risks to businesses and the financial markets, and is one of the many sources of structural change affecting the financial system.[4] However, it has distinctive characteristics that mean it needs to be considered and managed differently from standard risks. These include far-reaching impacts in breadth and magnitude, foreseeable nature, irreversibility and dependency on short-term actions. There is an increasing amount of work happening in international fora (such as the G20's Financial Stability Board, the Bank of England, the Network for Greening the Financial System, etc.) to understand and mitigate the impact that climate change will have on financial stability.

A first key step to mitigating the risk is to understand and measure it. Firm-level understanding of climate change risks can help drive business strategies that are more resilient to future shocks. Disclosure of the risks and how firms are managing it can help investors make more informed decisions about how they choose to allocate assets.

While there are many factors that investors may take into account in their asset allocation decisions, it is anticipated that having information about these previously unrevealed risks, and how firms intend to manage them, will generally result in greater investment flows towards less risky (i.e. low-emissions or climate resilient) activities, reducing overall systemic risk.

How New Zealand businesses and investors consider climate change

There are currently no express statutory requirements on New Zealand entities to consider and report on how climate change might impact the long-term strategy and viability of a company. There is very little high quality climate-related reporting in New Zealand, resulting from and contributing to, what the Reserve Bank Governor has called a 'thin' awareness of climate change in the financial system in New Zealand. As a result, the financial sector is underpinned by myriad unrevealed risks, which is driving mispricing of assets, misallocation of capital, and posing threats for the stability of the wider national economy.

New Zealand's financial markets

Currently, the New Zealand banking system is the predominant funding source for New Zealand firms. New Zealand's public market lacks depth: New Zealand companies are reluctant to list, with concerns including compliance, continuous disclosure standards and the mixed performance of IPOs (Capital Markets 2029). New Zealand is also dominated by SMEs.

New Zealand remains highly dependent on international investment. Foreign ownership in New Zealand equity markets is currently at 39%. To remain an attractive destination for investors, new standards and regulations in the financial markets must align with international best practice.

[4] Network for Greening the Financial System. April 2019. A call for action: climate change as a source of financial risk

Implications of existing policies and commitments for finance

New Zealand is a signatory to the Paris Agreement which, amongst other commitments, commits signatories to make "finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development" (Paris Agreement Article 2.1c). The Organisation for Economic Co-operation and Development estimates that US$6.9 trillion per year is required globally up to 2030 to meet climate and development objectives.

Moreover, New Zealand recently legislated a zero carbon target by 2050. This will require significant additional investment in climate mitigation and adaptation, and will require disinvestment from emissions-intensive and non-resilient activities. Financial markets will play a critical role here.

The COVID-19 economic backdrop

Domestically, the Treasury has identified that the economy is facing very challenging conditions. GDP fell 1.6% in the March quarter, primarily owing to the onset of COVID-19 related restrictions, with drought having a smaller negative influence. This was the largest quarterly fall in almost 30 years. The industries with the largest declines were construction (-4.0%), manufacturing (-2.4%) and transport, postal and warehousing (-5.2%). However, there are signs of improvement in the economy, and the Reserve Bank has noted that financial markets are functioning well. The nature, extent and duration of the underlying economic conditions remain unclear.

Current economic conditions will place stress on businesses, and some may feel that compliance with new regulatory requirements within the next few years will be an unwarranted burden. But drought has also added to the fall in GDP, so it follows that better management of climate-related risks (drought being one) can help mitigate this type of stress. COVID-19 has demonstrated that a better understanding of high impact but low occurrence risks is more important than ever. This has been reflected by stakeholder demand for the XRB to produce integrated reporting standards in the last three months, to help them better understand how non-financial factors can impact the resilience and viability of a company.

2.2 What regulatory system(s) are already in place?

The climate-related financial disclosures policy proposal relates to a range of existing regulatory systems, including the corporate governance regulatory system (which includes financial reporting and company law), the financial markets conduct regulatory system and climate change legislation.

The primary purpose of this proposed regime is to partially correct a market failure: that the costs of climate change are not internalised in financial analysis and therefore are not considered in business and investment decision-making. It intends to do so by generating new information about financially material climate change risk and opportunity, which can support more informed and accurate decision-making.

This policy is connected to the purpose of the Financial Markets Conduct Act 2013, which is to:

(a) promote the confident and informed participation of businesses, investors, and consumers in the financial markets; and

(b) promote and facilitate the development of fair, efficient, and transparent financial markets.

This proposal seeks to illuminate climate-related information that is currently not transparent within financial markets.

Although this is not the primary purpose, we also expect that revealing hidden climate-related risk and opportunities will have the outcome of making investment in low-emissions and resilient economic activities more attractive, thus helping to smooth the transition to New Zealand's 2050 zero carbon target.

Existing requirements related to climate-related financial disclosures

Section 211(1)(a) of the Companies Act 1993 includes a requirement to:

…describe, so far as the board believes is material for the shareholders to have an appreciation of the state of the company's affairs and will not be harmful to the business of the company or of any of its subsidiaries, any change during the accounting period in the nature of the business of the company or any of its subsidiaries…

This could be argued to include climate change risks. However, consultation submissions argued that this is not an appropriate mechanism for climate-related financial disclosures, as it is retrospective, and the requirements are not principles based. Moreover, section 211(3) provides for shareholders to agree to withhold potentially harmful information.

Existing fiduciary duties

A 2019 Chapman Tripp legal opinion on directors and scheme managers' duties regarding climate change concluded that:

…directors must act reasonably to inform themselves about, consider and decide how to respond to climate change risk, as they would any other financial risk; and …scheme managers must take climate change into account when making investment decisions and/or designing investment policies, where to do otherwise could pose a material financial risk to the investment portfolio.

Notably, this does not point to existing disclosure requirements for directors or scheme managers. Moreover, submissions to the MfE-MBIE discussion document argued that while the legal argument is clear, in practice this was not always the case. Several respondents reiterated the need for more explicit climate change disclosure requirements.

As the impacts of climate change are already being felt in New Zealand but there is no significant uptake in voluntary reporting frameworks, government intervention is needed because largely or solely relying on market forces has not proven to be sufficiently reactive.

This policy proposal could set a precedent for requiring greater consideration of climate change risks for a wider group of entities, including private companies and public agencies (although this may not include the disclosure element). It may also set the groundwork for extended external reporting requirements in the future that would increasingly acknowledge the need to disclose comprehensive forward-looking information about non-financial factors to help inform business and investment decisions.

Relationship with other regulatory systems

This proposal is also related to the work being done by the Council of Financial Regulators on climate change, and the work of the Reserve Bank of New Zealand as part of its supervisory function.

The Reserve Bank supports disclosure of climate risk as a tool that would help inform their monetary policy, supervision and financial stability functions.

This also relates to the 'Adaptation Reporting Power' under the **Climate Change Response Act 2002 (section 5ZW)**. The Adaptation Reporting Power provides the Minister for Climate Change or the Climate Change Commission with the power to request certain organisations to provide information on climate change adaptation. There will be some cross over between the organisations who may be required to provide information under the Climate Change Response Act 2002, and those who will be affected by climate-related financial disclosures. Moreover, the information requested under each may be very similar. Section 5ZW has been drafted in such a way to align closely with the TCFD framework, which also forms the basis of these proposals. We recommend using section 5ZW to ensure public entities disclose their climate-related risks and opportunities.

2.3 What is the policy problem or opportunity?

Businesses and investors face climate-related financial risks, through physical risk and transition risks, such as stranded assets in sunset industries, risks to plant and property, disruption to supply-chains, changing consumer preferences and reputational risks. At the same time, businesses have significant opportunities related to the low emissions transition. However, these risks and opportunities are currently not being considered and disclosed in a consistent and robust way across the financial markets, resulting in a likely overvaluation of emissions-intensive and non-resilient activities.

Existing financial impacts of climate change

Research by Frame et al. (2018) investigated the scale of the economic impact of climate-related floods and drought in New Zealand between mid-2007 and mid-2017. They conservatively estimate that flood and drought costs attributable to anthropogenic influence on climate are already somewhere in the vicinity of $120M per decade for insured damages from floods, and $720M per decade for economic losses associated with droughts. They warn that these costs will "*almost certainly*" increase over time. Already the annual cost of repairing land transport networks damaged by weather-related events has more than quadrupled over the past decade (Boston and Lawrence, 2018).

How New Zealand financial markets are responding

A December 2018 report from the Investor Group on Climate Change (IGCC) found that financial markets in New Zealand and globally are largely misaligned with climate change imperatives. There is a capital misallocation, due to issues ranging from market short-termism, asset mispricing, lack of information and awareness across financial markets and a number of other systemic barriers. This conclusion has been supported through our consultation with industry, and by the findings of the Sustainable Finance Forum.

Evidence of the problem

Current climate and sustainability reporting in New Zealand is not advanced, which suggests a shallow understanding within businesses and the financial markets of how

climate change might have impacts on the viability of certain businesses and sectors. Awareness of the TCFD recommendations remains relatively low, except amongst multinational firms who are seeing growing international pressure to disclose against them.

A 2018 working paper from New Zealand based think tank The McGuinness Institute found that 75% of annual reports from NZX-listed companies did not report on carbon emissions, while 71% did not disclose any environmental information. A 2019 report from sustainability consultancy Proxima found that despite doubling the overall number of listed issuers reporting sustainability-related information since 2018, uptake in recognised frameworks or external assurance of reports had not increased. Reporting quality remained static overall, and existing reports had made little progress in reporting methodology. While this policy is about the impact of climate change on a business, not the impact of a business on climate change (which leads primarily to carbon emissions reporting), this is indicative of the state of maturity on measuring and disclosing climate-related information.

In the MfE-MBIE Climate-related Financial Disclosures consultation run in late 2019, 85 per cent of respondents agreed with the problem we set out: that the market does not currently have the information it needs, and the status quo is not delivering information at the required pace.

While there is a market pressure to disclose financially material climate-related information already, there are two main reasons why retaining the status quo is likely to result in under-reporting of the climate-related information in financial markets:

- Early voluntary adopters may have concerns about the competitive disadvantage of revealing risks on their balance sheets if their competitors are not doing the same, creating a disincentive to disclose. A clear regulatory regime creates a level playing field.
- It is unlikely that a single high-quality climate reporting framework will be adopted without mandatory reporting. Under the status quo, entities will use different frameworks or report in ad hoc ways, undermining investor's ability to compare and make more informed decisions in the financial markets. Regulatory standards can help generate consistent information.

Respondents noted in particular that New Zealand can benefit from being an early mover internationally, and that disclosure can aid companies in managing climate-related risks and opportunities. Of that 85% however, 11 respondents went further to argue that climate change is a material risk to every company regardless of size, due to its systemic nature.

2.4 What do stakeholders think about the problem?

The stakeholders who responded to the consultation are as follows. These groups echo who we consider to be the overall affected and interested stakeholders.

Submitter type	Number of submitters
Business / industry	36
Industry group	11
NGO	8
Professional body	6
Individual	4
Crown entity	3
Local government	2
Legal professional	2
Iwi / Māori	2
Academic / research community	1
Unspecified	2

Businesses, financial institutions (who fall under 'industry' in the table above) and industry groups/professional bodies are interested because the policy proposals directly affect them or their members, as regulated entities.

NGOs and individuals have an interest in the environmental integrity of the proposals.

Consultancies, and accounting firms have an interest both as parties who have some experience of preparing disclosures of this nature (on a voluntary basis), and as a key stakeholder group who will benefit from the policy through the creation of new market demand for their services.

Over three quarters of total respondents supported the proposals set out in the discussion document. 84 per cent of respondents agreed that the TCFD is the most appropriate framework for New Zealand, and 79 per cent of respondents supported the introduction of new mandatory disclosure requirements.

The submissions we received from banks supported both mandatory reporting and including banks in the regime. The New Zealand Bankers' Association argued the status quo has not prompted a sufficient pace or level of disclosure to provide confidence that climate-related risks and opportunities are being integrated into decision-making.

Overall, three quarters of business and industry stakeholders who responded to the consultation shared our view of the problem and its causes, although some had disagreements as to the design of policy to address this (these issues are set out in section 3.1).

Stakeholders who do not share the agency's view

Ten responders to the consultation either opposed or largely opposed the proposals.

BusinessNZ argued there should be more consideration of other policy options before introducing mandatory disclosures. It proposed the idea of travelling up the 'regulatory pyramid'. This would include considering non-regulatory options first, moving up to generic light-handed options, and introducing more stringent measures such as regulation only if clearly warranted.

BusinessNZ's response did not reflect the view of several of its Major Companies Group and Energy Council members which submitted to our consultation document. The members' views were largely supportive, with 82 per cent of BusinessNZ Major Companies

Group and Energy Council members who responded supporting mandatory disclosures.

A small number of mining and minerals companies argued Government should uphold its commitment to an orderly and just transition via informed and rational policy settings. Mandatory reporting was seen to be unnecessary additional policy as companies already do or should identify, manage and report on material risks, including in relation to climate change.

Some asset managers argued there was no market failure which would be solved through disclosures. They saw the market as efficient at allocating capital, with asset managers considering all risks – including climate-related risks – to their investments as standard practice.

2.5 What are the objectives sought in relation to the identified problem?

The objective is to move to a position where climate change risks and opportunities are revealed and routinely considered in business and investment decision-making in New Zealand, to overcome information barriers that are leading to inefficiencies in the financial markets.

Doing so will help to direct more efficient allocation of capital; reduce systemic risk in the economy; help transition New Zealand to a low emissions and climate-resilient economy; and enable New Zealand to attract and retain international capital.

Section 3: Option identification

3.1 What options are available to address the problem?

This policy analysis is focussed on designing a mandatory (comply-or-explain) climate-related financial disclosure system. This includes:

- the problem we are seeking to address (the 'why')
- the appropriate scope of entities are captured by the regime (the 'who')
- what framework should be used for reporting (the 'what')
- the appropriate time frames for commencement (the 'when')
- where disclosures should be made, how this will be enforced, what legislative vehicle this should sit in, and what tools the government needs to provide to enable implementation (the 'how')

80 per cent of responses to the MfE-MBIE discussion document question 'do you favour retaining the status quo or new mandatory disclosure requirements' opted for new mandatory requirements. They argued that we have to act because the status quo will not achieve the policy objectives, improving understanding of climate risks for financial stability is urgent, and there is a need for consistency of approach and legal clarity.

Option 1

One option is not to regulate, but to focus on awareness raising, education and establish new enforcement mechanisms for the existing requirements, through the NZX listing rules and the Companies Act 1993. This would seek to encourage all companies and investors to consider and report climate-related financial risks and opportunities.

The Government could provide additional clarity by publishing guidance stating that the status quo should not be thought of as voluntary, in light of existing director's duties. Alternatively, these options could progress alongside regulatory options to complement legislative changes.

Evidence from the consultation suggested that relying on a non-regulatory option would not be effective. The status quo:

- is not driving change with sufficient urgency
- results in inconsistent and incomplete reporting through different reporting frameworks, making it very challenging for users to compare disclosures made by different entities
- raises concerns about entities opening themselves up to competitive disadvantage by revealing climate-related risks to their businesses if their competitors are not doing the same.

Discussions with policymakers overseas have revealed that an early preference to trial voluntary reporting alongside a statement of expectation for disclosure has not proved sufficiently successful, and that mandatory regimes are now being considered.

Option 2

Introduce new mandatory reporting requirements, using the TCFD framework as a basis for new reporting standards.

Who

The disclosure requirements would apply to financial institutions and other entities that participate in financial markets comprising listed issuers, managers of registered investment schemes, banks and licensed insurers. These entities are proposed as the regime is designed to use the levers available in the financial markets to drive a change in investment patterns. These classes of entity are all regulated under financial markets legislation through the Financial Markets Conduct (FMC) Act 2013.

This would apply to all banks, and managers of registered schemes with greater than $1 billion in total assets. In addition to using the same $1 billion asset threshold, insurers will be included if their annual premium income is greater than $250 million. Assets under management alone do not provide an accurate picture of risk exposure for insurers. The inclusion of premium income as an alternative measure to total assets is needed to provide a proxy for liability-side risks for life, general and health insurers. The regime intends to apply to all listed issuers, with no exemption threshold. These thresholds capture approximately 90% of the financial assets under management in New Zealand.

This threshold would apply to the designated types of financial market participants which as at the last day of each of the 2 most recently completed financial years before the relevant time controlled, by the person or entities controlled by the person, is within the threshold. This is in keeping with the current approach of the FMC Act.

Crown financial institutions as state-owned investment funds that invest in financial assets, would also be included to promote better decision-making, ensuring ability to pay out liabilities on an enduring basis, and to promote accountability to Parliament and taxpayers.

What

The main purpose of disclosing climate-related financial information is to provide information about material financial risks and opportunities to the users of their financial reports. Hence, it is important for the disclosures to appear in the same report in which they make their mainstream financial disclosures.

Disclosures would be made on a comply-or-explain basis: non-disclosure would be permissible in the case that an entity analyses and reports that they see themselves as not being materially affected by climate change, with an explanation as to why (including details on the assumptions on which their analysis was based). Where there are genuine challenges to disclosing (for example, inability to source data after taking a best endeavours approach) this could also be explained, with a roadmap on how to manage those challenges in the future. Any disclosure would be subject to a financial materiality test, as defined by the XRB.

Standards would be set by the XRB, and the disclosures would be monitored, enforced and reported on by the FMA. As an independent Crown Entity, the XRB would therefore set the timing for commencement, with advice from MfE and MBIE. MfE will coordinate the necessary guidance on climate scenario analysis and any relevant data requirements.

Information disclosed would not need to be assured initially, with the exception of any greenhouse gas emission data, where assurance practice is already mature. Disclosures would be made annually.

The regulatory regime would be reviewed within 3 – 5 years, at which point key features of the regulatory design, such as scope, thresholds and mandatory assurance will be reassessed.

Option 3

As with option 2, but expanding the scope of reporting entities to non-listed companies. This could potentially extend to: high emitting companies, all large companies and highly climate-vulnerable companies.

The majority of companies in New Zealand are unlisted. Restricting the scope of reporting entities to listed companies may leave significant risks to financial stability unmanaged, and make it more challenging for banks, insurers, managers of registered schemes and Crown financial institutions to analyse their exposure. Moreover, this may create a less level playing field between public and private companies.

However, non-listed companies are not required to lodge financial statements with the Registrar of Companies or otherwise publish them. Requiring climate-related financial disclosures to be disclosed in isolation of the companies' mainstream financial reports would not be in keeping with the intervention logic of this regime. This was supported by our further stakeholder engagement, where it was suggested by banks that public disclosure is a 'bad fit' for non-listed companies.

Respondents to the 2019 MfE-MBIE consultation showed some support for extending the scope, but this was not specifically consulted on. We therefore consider it is not appropriate to extend the scope of this regime without adequately consulting the affected population.

Other policy design options

Many policy design variables were considered within the three main options set out above. We set out our analysis of these options below.

Scope of regulated parties

A. All listed issuers vs NZX50 only

It was suggested that the initial mandatory requirement only apply to the NZX50 to allow them to develop a quality benchmark for others to follow. This staged approach would allow a longer period for implementation.

Although we agree that NZX50 companies should, as a general rule, be better placed to produce higher quality disclosures than some of the smaller issuers, we consider that learning-by-doing will be an essential part of improving the quality of disclosures over time. Delaying implementation will delay the benefits of disclosing and will undermine the effectiveness of reporting higher up the investment chain.

We considered whether listed debt issuers should be included within scope of the regime. Our conclusion was that information on the underlying climate-related risks and opportunities of debt issuers to be vital in accurately valuing issued debt. Investors would require a higher coupon rate from issued debt if their investment is at a higher risk of defaulting than what is currently revealed to the market, and vice-versa.

B. Managers of investment schemes

During the consultation, a number of asset (fund) managers suggested that the category should be subject to an extended transition period (e.g. 3 – 5 years after listed issuers are required to disclose) to allow sufficient time for high quality data to be drawn down. An alternative suggestion was to allow them to only report certain elements, with the more data-heavy elements to remain voluntary initially.

We have concluded that asset managers should be included in the regime in full, despite the initial practical challenges to disclose on certain elements.

Requiring asset managers to take part in the regime from the beginning will create greater pressure on their investee companies, resulting in a virtuous circle of information provision. There is existing guidance for asset managers to undertake climate risk analysis. For example, guidance from the Institutional Investors Group on Climate Change suggests that investee data is only one data set that should be included in climate impact assessments. The guidance suggests:

> "Until the breadth and depth of physical climate risk disclosure improves, investors will likely need to conduct their own analyses…most of the current TCFD-style disclosures do not yet present investors with decision useful information… Direct engagement… may be an alternative to relying on disclosures until the quality improves. Investee climate risk disclosure practices will likely become more comprehensive and sophisticated as time passes. Investors will have a role to play in ensuring decision useful information is increasingly disclosed. To enable better analysis, for example, investors should consider working amongst themselves to determine what types of physical risk-related disclosures are most useful. They can then work with investees to make their preferences clear."

Furthermore, as Executive Sponsor of the Bank of England's work on climate change, Sarah Breeden recently stated: "We recognise that there are some areas where the science, data or tools are not yet sufficient to estimate risks accurately. But in these cases firms can and should explore the use of reasonable proxies and assumptions to work

around these issues, rather than leaving risks unrecognised. Imperfection is not an excuse for inaction."[5] This reflects our recommended position.

Flexibility through the 'comply-or-explain' dimension of the regime means that asset managers may explain during the initial years of the regime until such time that the investee entities have disclosed the requisite information for asset managers to interpret, analyse and report.

C. Wholesale funds

Wholesale funds may only be invested into by eligible wholesale investors, which either: have significant investment activity; are a large investor; are a financial adviser; or invest in financial products as their principal business. Wholesale funds include KiwiSaver Schemes, Superannuation Schemes, unit trusts and group investment funds, household and non-profit organisation investments.

KiwiSaver Schemes and Superannuation Schemes are required to publicly release financial reports via the FMC Act 2013, and would therefore be included in the regime as proposed. The remaining wholesale funds (approximately 30 per cent of the wholesale fund market) are not currently required to publicly release financial reports. These wholesale funds are predominantly unit trusts, with a small proportion made up of households and non-profit organisations.

Unit trusts were provided an exemption from producing public financial statements in 2017. The FMA considered an exemption appropriate for two main reasons:

- financial statements in relation to the scheme as a whole are not meaningful for investors in one of the separate funds, and investors will have no recourse to assets of other separate funds of the scheme, and
- each separate fund is required to produce financial statements relevant to investors for assessing risk and performance.

Following the FMA's reasoning, unit trusts would not be included in the regime.

Personalised investments such as private wealth, household and non-profit organisation wholesale funds would not be included in the regime. In these cases, the party with legal ownership of assets (i.e. the client) is able to directly influence investment strategies and may request information about climate risks and opportunities. Our primary objective is for business to disclose clear, comparable and consistent data to empower routine consideration of climate change in business and investment decisions. Public disclosure from private wealth, households and non-profit organisations will not provide additional decision-useful information to the market.

D. Building societies and credit unions

Building societies and credit unions are included as FMC reporting entities with higher levels of public accountability. We did not explicitly include reference to NBDTs in the consultation. However, we consider that those NBDTs with more than $1 billion of total assets would be included. This would ensure banks and NBDT's of the same size would be treated the same in the regime.

Exemption thresholds

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[5] Bank of England. July 2019. *Leading the change: climate action in the financial sector – speech by Sarah Breden.*

We considered a wide range of exemption thresholds, including not having exemption thresholds and allowing a less onerous version of reporting for smaller entities instead; exemption thresholds for listed issuers based on market capitalisation; and varying thresholds across banks, insurers and managers of registered schemes depending on the proportion of the market captured under each. Tables 1 – 3 below outline exemption options using dollar thresholds as a proxy for economic significance

We have recommended a common threshold across all categories other than listed issuers and insurers, for the proportionality and minimisation of regulatory complexity.

Dollar thresholds would be increased from time-to-time to reflect movements in a suitable index maintained by Statistics New Zealand. This would ensure that smaller entities do not get drawn into the disclosure regime.

Table 1: Registered banks (NZ incorporated and branches of overseas companies)

	Number of banks	Total assets ($b)	Percentage of total assets
All registered banks	26	602.1	100%
Assets >$1b	**23**	**601.4**	**99.9%**
Assets >$3b	14	582.2	96.7%
Assets >$5b	12	573.6	95.3%

Table 2: Investment scheme (asset) managers

	Number of scheme managers	Total assets ($b)	Percentage of total assets
All scheme managers	105	146.4	100%
Assets >$0.5b	34	139.4	95.2%
Assets >$1b	**23**	**132.6**	**90.5%**
Assets >$3b	12	114.5	78.2%
Assets >$5b	5	70.5	48.4%

Note: The above table includes all investment schemes required to report under the FMC Act including retail funds, KiwiSaver, Superannuation and other retirement schemes.

Table 3: Licensed insurers – assets (>1b) and premium income

	Number of insurers	Total assets ($b)	Percentage of total assets	Total premium ($b)	Percentage of total premium
All licensed	84	21.8	100%	12.2	100%
Premium >$100m and/or $1b assets	20	19.0	87.0%	10.1	82.6%
Premium >$ 0.25b and/or $1b assets	**12**	**16.4**	**75.3%**	**8.7**	**71.4%**
Premium >$0.5b and/or $1b assets	7	14.3	65.5%	7.1	58.4%
Premium >$1b and/or $1b	6	14.2	65.0%	6.6	54.3%

Comply-or-explain

We initially proposed that 'comply-or-explain' meant 'explain' would only be permissible in the case that an entity analyses and reports that they see themselves as not being materially affected by climate change, with an explanation as to why.

As a result of stakeholder feedback on allowing more flexibility, and with respect to the data availability concern (see section 6.2), we have amended our position on this.

Assurance

The audit profession is arguably well placed to skill-up rapidly in order to provide assurance over disclosures. However, auditing and assurance standards are largely focused on expressing opinions about historic financial information. Much of TCFD is forward-looking qualitative information. We do not consider that assurance practice is currently sufficiently mature in this space. This was confirmed by the consultation feedback. We do expect climate related assurance to mature rapidly with market demand however.

Standard setting

We initially considered that the XRB may not set standards in this area. An alternative would be for MfE and MBIE to provide a set of existing resources to use. This would be iterative and flexible, which would reduce comparability and consistency in the short-term, but could facilitate 'learning by doing'. However we concluded that the XRB, as a trusted and respected standard setter, is far better placed to perform this role and will give greater confidence to the market.

Reporting in annual and financial reports

We considered whether or not regulated parties should be able to report in separate TCFD reports, or in sustainability reports. However we do not believe that doing so will be successful in ensuring climate change is considered as a boardroom issue, and will not then provide decision-useful information to investors in the context of financial information. We therefore recommend that disclosures should be made in mainstream filings, such as annual reports.

Safe harbour provisions

There is some concern that forward-looking risks identified in a financial report will be

considered a forecast or prediction, rather than a risk analysis exercise. For example, directors may be sensitive to disclosing forward-looking information without conducting a thorough verification process.

It is our view that if a company carries out a robust and good-faith risk assessment in line with the TCFD recommendations, and is not reckless or fraudulent about their findings (including disclosing qualifications and uncertainties), there will be negligible risk of disclosure-related liability where the company's assessment turns out to be incorrect. Existing principles-based safe harbour provisions in the Financial Markets Conduct Act 2013 (s499 and 501) mean we do not consider it is necessary to include additional provisions here.

3.2 What criteria, in addition to monetary costs and benefits have been used to assess the likely impacts of the options under consideration?

Proportionality – options for thresholds consider the proportion of the market captured, to ensure that the regime does not unduly burden smaller entities, whilst having the greatest possible impact.

Minimising regulatory complexity – considering the many types of entity in scope of our analysis and their very different structures, sizes and activities, a key criteria for assessing options was minimising regulatory complexity.

There were some trade-offs required between proportionality and minimising regulatory complexity, as the optimum threshold for one category of entity in scope was not the same as another category.

Flexibility – climate-related financial disclosures remains relatively nascent and continues to develop as it matures. It is important therefore for policy options to embed flexibility for this to develop in line with international developments.

There is also a trade-off between minimising regulatory complexity (i.e. providing business certainty) and allowing for flexibility.

Increasing the amount of information available to the financial markets - the regime is designed to use the levers available in the financial markets to drive a change in capital allocation in a mutually reinforcing information flow.

For many of the actors higher up the investment chain, analysing their own risks and exposures becomes more challenging if underlying companies do not disclose their risks, so the greater the number of disclosing entities, the more effective this will be.

Practicality – policy options were considered for how practical implementation would be, including issues around access to data, the amount of support and guidance required for business to implement the regime, realistic time frames for being able to start reporting, and fit with existing market behaviours and regulatory regimes.

International developments – as financial markets are inherently international in nature, this policy proposal was developed in step with latest developments internationally to reduce friction for cross-border transaction and to continue attracting international investment to New Zealand. We anticipate the development of standards and guidance in New Zealand will be iterative as international best practice continues to develop.

3.3 What other options have been ruled out of scope, or not considered, and why?

The options considered were within the overall framework of the Productivity Commission’s report recommendations and Government response. We have not gone beyond that scope in our analysis.

Section 4: Impact Analysis

Marginal impact: How does each of the options identified in section 3.1 compare with taking no action under each of the criteria set out in section 3.2? *Add or subtract columns and rows as necessary.*

	No action	Option 1: Awareness raising, education and enforcement of existing requirements	Option 2: Mandatory reporting requirements using the TCFD framework	Option 3: Mandatory reporting requirements using the TCFD framework with increased scope
Proportionality	0	**0** No change	**+** recommended threshold captures around 90% of the assets under management in the financial markets and minimises burden for smaller entities	**0** A larger scope of reporting entities would capture a larger number of entities. Without consultation we cannot know if this would be proportional.
Minimising regulatory complexity	0	**0** No regulatory change	**0** New regulations add complexity for regulated parties, but the single size threshold for most entities reduces this as far as possible. Making expectations about disclosures explicit also creates greater regulatory clarity	**-** Issues as with option 2. Additional entities in the scope may increase regulatory complexity, as new disclosure regulations will need to be introduced for non-listed companies
Flexibility	0	**0** No change – significant flexibility in reporting	**+** Enabling a more flexible 'comply-or-explain' mechanism provides scope for explaining, but mandating a format reduces flexibility as to how and what information is disclosed	**+** Enabling a more flexible 'comply-or-explain' mechanism provides scope for explaining, but mandating a format reduces flexibility as to how and what information is disclosed
Increasing amount of information	0	**0** A number of companies will start to undertake reporting, which will help with capital allocation, but entities likely to continue using different reporting frameworks and different parameters for reporting,	**+** Disclosure amongst the main financial market participants will enable the financial markets to start pricing in climate risks and opportunities	**++** Comprehensive disclosure will enable the financial markets to work more efficiently than no or partial coverage

		undermining comparability of information		
Practicality	**0**	**0** No real change. some additional costs to Government associated with education and awareness-raising campaign	0 The FMC Act has a clearly aligned purpose, so regulatory implementation is straightforward. Data challenges associated with requiring some entities to disclose. Additional costs to the Government associated with supporting implementation, and to regulated parties in undertaking new activities	- - Same challenges as for option 2, but a new type of reporting requirements will need to be introduced for non-listed companies, who may need a longer time to skill up. Poor quality reporting amongst this group may undermine the effectiveness of the regime. Monetary costs also higher for regulated parties and regulators. It would be inappropriate to capture this group without consulting
International developments	**0**	- No change. As other jurisdictions, and international investors increasingly expect this information, New Zealand will fall behind	++ New Zealand at the forefront of incorporating climate risk and able to attract international investment	+ New Zealand seen as a leader, but may also become an outlier by going beyond what other countries are considering
Overall assessment	0	**0**	++	+

Key:

++ much better than doing nothing/the status quo

\+ better than doing nothing/the status quo

0 about the same as doing nothing/the status quo

\- worse than doing nothing/the status quo

\- - much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options is likely to best address the problem, meet the policy objectives and deliver the highest net benefits?

Option two is our recommended option. We consider that mandatory reporting requirements are required to meet the policy objectives.

The scope of reporting entities has been chosen in keeping with financial market participants, noting the purpose of the FMC Act 2013. The $1 billion threshold across all parties other than listed issuers (and the additional premium threshold for insurers) minimises regulatory complexity while remaining largely proportional. The comply-or-explain element enables flexibility and practicality of the regime.

We view the proposals as a first step towards more widespread adoption of the TCFD framework. We therefore note that the scope of the regime may be expanded in future years, subject to appropriate consultation.

Consultation process

In October 2019, we released a discussion document on climate-related financial disclosures. The document's proposals outlined the design of a comply-or-explain disclosure system for New Zealand.

We received 77 submissions to the consultation, with 77% of respondents either supporting or largely supporting the proposals. The proportion of business/industry respondents who would be regulated entities that supported or largely the proposals was only slightly lower, at 76%. The feedback received has been taken into account in developing policy proposals.

Consultation events

The Ministry for the Environment and the Ministry of Business, Innovation and Employment held four public consultations in Auckland, Wellington and Christchurch in late November 2019, as well as a public webinar in early December, providing opportunities to engage with stakeholders. We invited stakeholders who would likely be impacted by the proposals to attend, to increase the chance that relevant stakeholders would engage with the discussion document. Total attendance across all five sessions was 151 people.

Further consultation

We have also engaged further with key stakeholders groups to better understand the issues they raised in their submissions, and to test out policy options. This includes meeting with a group of large banks and utilities companies, with a group of fund managers and further meetings with individual fund managers, and discussions with iwi.

In addition, we have tested our assumptions and thinking with policymakers abroad who are currently considering many of the same policy issues, and have found that our recommended approach is broadly consistent with their current thinking.

Consultation with other agencies

We have further consulted with the Treasury, the Reserve Bank of New Zealand, the External Reporting Board, and the Financial Markets Authority.

We have given due consideration to the feedback received through consultation in our preferred policy options and captured that feedback in this document.

Consultation respondents who opposed the proposals

Stakeholders who opposed the policy proposals did so for the following reasons:

- The proposed regime will add additional regulatory burden and cost
- It is difficult for asset managers to obtain high quality data on investee companies (particularly international companies who are not captured by this regime) and there will be a lag between when the regime begins and when asset managers will have access to underlying investee information.
- If there is insufficient time to 'gear up', that will lead to poor quality information being disclosed

Evidence and Assumptions

Managed investment schemes

A key issue we considered in drawing of thresholds was how this would impact managers of investment schemes, since they have revenue model based on commission.

We started with assumptions related to compliance cost. Evidence was drawn from consultation with a market leading data provider, who estimated that providing carbon and climate-risk related metrics for an fund manager's investment portfolio typically costs between $10,000 and $40,000. This cost varies based on scale and scope. For example, smaller entities, or entities which invest only in New Zealand will incur lower costs, whereas larger entities investing globally will incur higher costs. Scenario analysis can cost between $70,000-150,000. We are therefore working on the assumption that average costs to a managed investment scheme may be from $80,000-$190,000.

Evidence of average operating revenue and expenses was collected from financial statements of ten large asset managers. Profit margins and the cost of fund-by-fund disclosure with aggregate data were clarified through consultation with asset managers on a confidential basis, given the commercial sensitivity of the information.

For investment scheme managers with multiple funds, additional costs for disclosure on a fund-by-fund basis was estimated to be 1% of the total cost of disclosing on aggregate funds. This is because collecting data for an aggregate portfolio also provides all of the necessary information to produce fund-by-fund disclosures, spreading the cost across the full range of funds.

The average management fees per fund (weighted by value) are estimated at 1.42%. The operating margin (operating earnings divided by revenue) for funds range from 65% to 95%. Retail funds are more expensive to run than wholesale as they have additional legal costs. More aggressive funds are also more expensive to run relative to cash and fixed interest.

The average weighted aggregated operating margin across surveyed asset managers is 86.33%. Assuming weighted fees (1.42%), and assuming minimal costs for disclosing on a fund-by-fund basis (1%), we estimate compliance cost as a 0.92% decrease in operating

profit for asset managers at the $1 billion threshold. The decrease in operating margin relative to compliance cost is assumed to decrease as assets under management increase, as many of the costs are relatively fixed.

Noting the lack of quantitative evidence of compliance costs, Table 4 outlines the impact of four cost level scenarios, which set out the estimated impact on operating margin for investment scheme managers, using the cost range of $80,000–190,000 as set out above. A fourth scenario of $720,000 adapts the FCA's estimate of a medium sized UK-based listed company as a 'high' cost scenario.

Note the below table is based on a scheme manager with exactly $1 billion in assets under management, as this is where we expect the relative cost to be greatest. The bolded column indicates what we estimate to be the most accurate scenario for compliance costs.

Table 4: Cost impact on managed investment schemes' operating margins

Operating margin before compliance costs	**86.33%**			
Compliance costs (4 scenarios)	$80,000	**$130,000**	$190,000	$720,000
Decrease in operating margin due to compliance costs	0.56%	**0.92%**	1.34%	5.07%
Operating margin after compliance costs	85.77%	**85.41%**	84.99%	81.26%

The increase in costs for managers of registered schemes are likely to be passed on to investors through increased fees. Assuming these costs are directly and evenly passed on to KiwiSaver members, we estimate a $0.65 increase in fees per member per year, or an increase of 0.40%. There are 14 KiwiSaver providers with assets under management greater than $1 billion, resulting in a total increase in costs of $1,820,000 spread across their approximately 2.8 million members. (2019 FMA KiwiSaver annual report)

Noting the lack of quantitative evidence of compliance costs, table 5 estimates the increase in KiwiSaver fees per year under the four cost level scenarios from the previous table. Note the average KiwiSaver fee in 2018 was $163.53 per annum. As mentioned above, this table also assumes the increase in fees are directly and evenly passed on to KiwiSaver members. The bolded column indicates what we estimate to be the most accurate scenario for compliance costs.

Table 5: Cost impact on KiwiSaver scheme fees

Average KiwiSaver fees before compliance costs	**$163.53**			
Compliance costs (4 scenarios)	$80,000	**$130,000**	$190,000	$720,000
Increase in KiwiSaver fees	0.25%	**0.40%**	0.58%	2.21%

KiwiSaver fees after compliance costs	$163.93	**$164.18**	$164.48	$167.14

Cost assumptions for listed issuers

Although the great majority of industry representatives that we consulted with were unable to provide quantitative evidence for cost of compliance, we received a range of cost estimates for key elements of activity needed to prepare a climate-related financial disclosure. These costs estimates were received from a major global accounting firm, and one of the largest companies in New Zealand, which is GHG-emissions intensive and has over $1 billion in annual revenue. We expect that costs will vary significantly depending on the size and complexity of a disclosing organisation, as well as the financial materiality of climate change risks upon it.

Likely areas of cost and indicative figures (from large corporate companies):

Greenhouse gas (GHG) inventory: $10-50,000
GHG assurance: $30-100,000
Scenario analysis: $70-150,000
Advisory services: $10-20,000
Investment data from a research provider: $10-$40,000
Carbon analytics tool: $6,500 per portfolio

We include this for context, but do not intend to quantify costs in the below table, as there is significant uncertainty as to whether these costs would be the same across smaller companies, or companies that undertake significantly different activities.

For further context S9(2)(ba)(i) This proposal is therefore likely a meaningful additional expense for many organisations, depending on the level of detail they decide to go into. However we note that this is more than an audit exercise. Instead it is a strategic risk management exercise. As one bank told us, "in effect, this work is expensive. However, most of it is not about complying with possible legislation but genuinely assessing our risks and opportunities. This is something we would likely be doing regardless of any new regulatory obligations."

We are conscious that the most costly element of this regime is likely to be scenario analysis. Consultants suggested this is likely to cost between $70,000 and $150,000 per entity. Scenario analysis is more expensive partly because entities require bespoke products in the absence of an accepted standard. This approach is also causing a lack of standardisation in outputs. The development of standards and 'off the shelf' scenarios developed by government will significantly reduce the costs in this area. MfE intends to commence work on this in 2020.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment**: *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach compared to taking no action			
Regulated parties	Cost will be ongoing, although there are likely to be higher one-off costs in the initial years as regulated parties who have not yet started to consider their climate-related impacts will need to establish new processes. The marginal cost is challenging to calculate, since this regime is bringing forward costs that we expect would otherwise have been incurred (with increasing expectations in international financial markets relating to production of climate-related financial disclosures), but potentially reducing costs by standardising the reporting requirements, and by Government providing guidance materials. There is significant flexibility in the regime as a result of being on a comply-or-explain basis. Where companies 'explain', whether in whole or in part, validating their view shouldn't be a significant cost. We anticipate that for many regulated entities, the bulk of the costs will be associated with staffing or consultant costs to undertake analysis. Ultimately the cost will depend significantly on the size and type of company, the maturity of their	Unable to accurately quantify and variable across organisations, but likely to be medium.	Low - as noted in section 1.2 there is a lack of quantitative evidence available

	existing sustainability and risk reporting practices, and their commitment to understanding climate-related financial risks and opportunities.		
Regulators	The FMA will have short-term 'start up' costs to for hiring and upskilling staff on this new function. It will then have ongoing costs related to monitoring and enforcement.	S9(2)(f)(iv)	High – this is based on FMA estimates, validated by MBIE
	The XRB will need to build capacity, employ specialist staff, establish a new Extended External Reporting Board or Panel and start working on standards development. Costs will be ongoing.	S9(2)(f)(iv)	High – this is based on estimates of current Accounting Board funding
Wider government	Front-loaded cost to Ministry for the Environment to develop climate change scenarios for use (this ties in with other existing workstreams within MfE), and ongoing costs to keep those scenarios up to date.	Medium	Low – as there are multiple concurrent work streams, this has yet to be fully scoped
Other parties	There will be increased fees for investors in managed investment schemes.	$0.65 increase in KiwiSaver fees per member per year, or total of $1.82m per year. Similar fees increases for other investors	Medium
Total Monetised Cost		Minimum $25m + compliance costs over first five years	Low

Non-monetised costs		None of note	

Expected benefits of proposed approach compared to taking no action			
Regulated parties	Ongoing non-monetised benefits, largely through better information provision, better risk management and illuminating new commercial opportunities. This may lead to ongoing monetised benefits.	Medium	Low
Regulators	Ongoing non-monetised benefits of greater financial stability and market transparency	High	High
Wider government	Ongoing non-monetised benefits of better understanding of hidden risks across the economy	High	Low
Other parties	Ongoing monetised benefits of new market demand for advisory services. Ongoing non-monetised benefits to societal stakeholder from increased financial stability, better oversight of public spending, and likely action towards reducing emissions and investing in climate resilience.	Medium High	High Medium
Total Monetised Benefit	New jobs and markets created and likely additional funding for low-emissions and resilient goods, products and services.	Medium	Low
Non-monetised benefits	More efficient financial markets, less climate-related risk.	High	High

5.3 What other impacts is this approach likely to have?

We expect that achieving this objective will have several macro-economic level impacts, including:

a. reducing systemic risk in the economy;

b. helping transition New Zealand to a low emissions and climate-resilient economy;

c. ensuring we are aligned with international best practice; and

d. enabling New Zealand to attract and retain international capital.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

Legislation

Primary legislation will be needed to specify the classes of entity that are required to disclose. This will be implemented through the Climate Change Financial Regulation Bill, which has a Category 5 (instructions to be provided to the Parliamentary Counsel Office later in the year) priority in the 2020 Legislation Programme.

The FMA and XRB will have crucial roles for enforcement and success of the policy being enacted. An Order in Council would be required under section 17(2) of the Financial Reporting Act 2013 to give the XRB the power to issue extended external reporting-related standards, including climate-related standards. No legislative arrangements are required for the FMA to take on new functions.

Ongoing responsibility for the operation and enforcement of the new arrangements will be jointly held by the FMA, the XRB and MfE. All parties have confirmed their ability to implement the proposals, subject to receiving adequate resources to discharge these new functions.

Enforcement

The question of appropriate enforcement is a matter for the FMA to decide, as an Independent Crown Entity. The FMA's current approach to enforcement is to respond in a proportionate manner, targeting conduct that harms or presents the greatest likelihood of harm to promote fair, transparent and efficient financial markets. It intervenes early where there is misconduct such as misinformation and criminal action is only taken where there is evidence of intentional, reckless, or other serious unlawful conduct. We do not consider that criminal penalties will therefore be a feature of this regime.

Implementation

Subject to the legislation being enacted by mid-2021, we anticipate mandatory (comply-or-explain) climate-related financial disclosures would come into force for financial years commencing on or after 1 January 2022. This would mean, for example, that an entity with a 30 June balance date would first be required to comply or explain in relation to the financial year ending on 30 June 2023. Exact timing will be dependent on how long it takes the XRB to set standards. We expect that this allows sufficient preparation time for regulated parties.

The Government will assist businesses by providing tools, such as off-the-shelf climate models that will help regulated entities carry out scenario analyses (see TCFD Strategy disclosure (c)). These climate models would provide improved comparability and consistency through usage of homogeneous scenarios by reporting entities. We propose that MfE will have the lead responsibility for coordinating this activity.

Stakeholders will be highly involved in implementation, as we intend to work closely with regulated parties to understand what they need from guidance. This may take the form of pilot reporting projects, or workshops with regulated parties. The XRB intends to undertake extensive consultation with stakeholders when developing standards; deliver a communication plan targeting regulated entities; undertake awareness raising, education and constituency engagement; and develop a resource base for stakeholders.

6.2 What are the implementation risks?

Poor compliance: if regulated parties feel that the regulatory regime is impracticable, there is a risk that they do not comply, or comply with a low quality of disclosure. Similarly, if regulated parties consider climate-related financial disclosures a compliance burden only and do not see the value of the exercise, the value of their outputs will be low. If so, poor compliance may result in this regime being treated similarly to the status quo, where arguably there is already a legal obligation, but poor compliance and enforcement result in it being seen as voluntary.

In addition, the volume of legislative reform in the industry will necessitate prioritisation of limited resources. Compliance is dependent on sufficient resourcing based on the population's assessment of competing priorities.

To support implementation, this can be mitigated through concerted stakeholder engagement and education for capability building. The XRB would aid businesses by developing, consulting on, and issuing new reporting standards and guidance material to assist entities with compliance. We also consider this to be the international direction of travel, so we believe this is accelerating existing market forces that will affect entities within the next few years anyway.

Some entities may initially try to use 'explain' as a way of not complying, but the level of information required as part of that function, including assumptions and pathways to disclosing will mitigate this to some extent. Furthermore, we anticipate that market pressure will come to bear on those entities who do not disclose or disclose poorly.

Data availability: Currently, there is little information available on company-level emissions or climate risks. Stakeholders expressed concern that it will take several years for high-quality, decision-useful data to filter through to the market. Compliance for entities further up the investment chain could therefore be challenging, as their analysis of climate-related risks and opportunities will rely on the availability and quality of data they can obtain about underlying investees. This will be particularly challenging for those fund managers invested in highly diversified portfolios with stocks in hundreds of companies.

Where there are genuine challenges to disclosing (for example, inability to source data after taking a best endeavours approach) this could also be explained, with a roadmap on how to manage those challenges in the future. This can also be mitigated over time through greater ongoing education and awareness-raising to ensure that companies are disclosing. As set out above (section 3.1), there is also already guidance on how investment managers can consider risk without a full set of data of underlying companies, including by taking a sector-based and/or materiality-based approach to risk management.

Buy-in and capability

Our underlying assumptions are that stakeholders, particularly those at the top of the investment chain, have a desire to understand their long-term risks, and will use the information revealed through disclosures to move away from short-term decision making alone.

We are aware that there is low capability within New Zealand at present to undertake the type of analysis that is required from this regime. However we consider there is real value

for organisations in undertaking the exercise from first principles, including having cross-business conversations about climate risk, rather than having an assigned disclosure team which does not require the organisation as a whole to think differently.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

At the beginning of the consultation period we noted there are five organisations that we are aware of who have disclosed TCFD-aligned reports or are planning to do so. We will continue to monitor the number of disclosing organisations annually as a measure of success. In particular we will rely on the monitoring function of the FMA and the Reserve Bank to understand how many regulated parties are disclosing.

It will be a challenging to truly measure whether businesses and investors are routinely considering climate change within their decision-making. One way of doing so is through the FMA monitoring the quality of the disclosures, and for MfE to pay particular attention to the 'Governance' aspect of the disclosures, which should reveal whether and how climate change is being considered at the Board level. Another area we will monitor closely is how many entities are choosing 'explain' and why – this will help to assess where greater support is required.

Third party reviews will also help to draw out a picture of the volume and quality of reporting – as noted earlier, the McGuinness Institute regularly reviews this for New Zealand – notably looking beyond the categories captured by this regime. This can help provide a system-wide view of whether regulations are encouraging voluntary uptake in non-regulated entities. The TCFD itself also publishes annual status reports on the international rate of uptake and quality of disclosures, which provides useful wider context.

7.2 When and how will the new arrangements be reviewed?

We recommend that there is a statutory obligation to review the regime within three to five years of commencement. This should include a review of reporting thresholds, scope, and assurance issues in particular. The review will be undertaken by the Ministry for the Environment and the Ministry of Business, Innovation and Employment.

An earlier review could be triggered by findings from the FMA that a large number of regulated parties were not complying or if the overall quality of disclosures are notably poor. The triggering threshold would need to be discussed with the FMA, in keeping with their approach to enforcement of other financial reporting regimes.

As we anticipate this is a first step in wider uptake of climate-related financial disclosures across stakeholders, we also consider there may be a 'phased' approach to introducing new entities to the regime. This will be triggered by a report back to Cabinet seeking agreement to do so.

Stakeholders will be able to raise concerns through workshops and guidance development ahead of the policy coming into effect.