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Author
Barbara Zonneveld
Director, Product Management

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85.2.2916.1121
clientservices.asia@moodys.com

Japan
+81.3.5408.4100
clientservices.japan@moodys.com

ISSB Sustainability Disclosure Standards: Unanswered Questions for Insurers

Summary

In March 2022, the International Sustainability Standards Board (ISSB) issued two sustainability disclosure exposure drafts. This initiated its ambitious aim to set a global baseline for sustainability reporting that will apply to all industries, including insurance.

The first of the draft standards sets general principles that the whole framework will follow. The second, focuses on climate-related financial information and is based on the Task Force on Climate-Related Financial Disclosures (TCFD) guidelines. Both exposure drafts aim to create global consistency in sustainability reporting, providing the users of companies' financial statements, such as investors, creditors, and lenders, with the information they need to measure enterprise value and make their decisions.

As with other International Financial Reporting Standards (IFRS), the ISSB invited public feedback. The deadline closed on July 29, 2022 and the ISSB will hold public meetings, starting in September 2022 to review the comments received.

This paper focuses on the areas of the proposals that are unclear and expected to lead to further Board discussions, so we expect some clarity in the coming months.

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Introduction

The ISSB is part of the IFRS Foundation. Set up following COP26, it aims to create a global baseline for sustainability reporting. It is likely that other regulators will follow its lead when creating new sustainability frameworks.

The first two standards, IFRS S1[1] and S2[2], have been delivered in proposal form. The ISSB invited and received feedback, and it will start to review the comments at public meetings starting in September 2022. It hopes that these two standards will be issued by the end of this year.

The standards will require organizations, including insurers, to deliver a wide scope of qualitative and quantitative disclosures, which will mean using new models, developing scenario analysis, and adjusting metrics, among other changes.

IFRS S1 – General Requirements for the Disclosure of Sustainability-related Financial Information

This standard covers general requirements for the disclosure of sustainability-related financial information. It creates a link between sustainability reporting and general financial reporting. IFRS S1 will be the basis for all future standards.

IFRS S1 is aimed at similar audience to general financial reporting standards: Investors, lenders, and other creditors. The two types of reporting also have a similar materiality concept. The ISSB states that sustainability disclosures should be reported at the same time as the other financial reporting. They should also be delivered by the same entity that issues general financial statements. However, the scope of sustainability standards may be broader, as they require that organizations consider their whole value chain when identifying risks and opportunities.

IFRS S2 – Climate-Related Disclosures

This standard specifies extra requirements for climate disclosures. IFRS S2 requires that organizations report on their plans for carbon transition and other adaptation and mitigation strategies. Transition plans will involve not only developing strategies, but setting measurable targets and monitoring progress. Reporting organizations will also have to quantify the effects of climate-related risks and opportunities and model their climate resilience under different scenarios.

The IFRS S2 appendix adopts Sustainability Accounting Standards Board (SASB) industry-specific disclosures – this does not exist in the TCFD framework. The insurance part of the appendix includes further quantitative disclosure requirements, including financed Greenhouse Gas (GHG) emissions, and expected losses from natural catastrophe risks, as well as quantitative disclosures such as product features that incentivize health and safety.

ISSB follows GHG Protocol requiring companies to report three kinds of emissions:

» Scope 1, direct emissions

» Scope 2, emissions from energy sources

» Scope 3, indirect emissions. For insurers, one of the main categories of Scope 3 are emissions from investment assets.

Measuring and reporting GHG emissions created by insurance liabilities is not required; however, insurers need to measure and report on the impacts generated by significant sources of transition risks. Policyholders and insurance products focusing on carbon-intensive activities will be exposed to transition risks, similarly to investees on the asset side of the balance sheet. So understanding carbon concentration on the liability side is equally as important for insurers to properly manage transition risks.

IFRS S2 also requires company-specific reporting on climate-related KPIs that are not covered by other metrics.

1 https://www.ifrs.org/content/dam/ifrs/project/general-sustainability-related-disclosures/exposure-draft-ifrs-s1-general-requirements-for-disclosure-of-sustainability-related-financial-information.pdf

2 https://www.ifrs.org/content/dam/ifrs/project/climate-related-disclosures/issb-exposure-draft-2022-2-climate-related-disclosures.pdf

Has materiality been defined clearly?

Similarly to other IFRS standards, the objective of the IFRS Sustainability Disclosure Standards is to provide the users of corporate financial statements, such as investors, creditors, and lenders, with the information they need to assess enterprise value.

For insurers, this can easily be understood as a requirement to disclose information about sustainability risks and opportunities that can have material impact on their current and future financial position, financial performance, and cash flows. There is a lack of clarity in the further guidance in the exposure draft of IFRS S1 suggesting that, when preparing financial disclosures companies may need to look not only at the risks that directly impact their financial performance, but also at their business's impact on the environment.

Such factors can indirectly impact enterprise value by, for example, triggering customer or regulatory actions. This suggests that the sustainability standards will have a much wider scope than that of typical financial reporting. In the current proposal draft it remains unclear how much further the sustainability disclosures will go, and where the boundary between the ISSB's proposals and "double materiality" is. If this uncertainty remains in the final disclosures, it could lead to different interpretations by preparers or their auditors.

In its final Report on Sustainability-related Issuer Disclosures, which was published in June 2021 and is one of the sources that the ISSB consulted when preparing its exposure drafts, the International Organization of Securities Commission went into slightly more detail[3]. The report notes that "There are reasons to believe that the trend going forward will be toward closer convergence of informational needs under the different materiality lenses." It explains that this is because if companies fail to manage ESG risks and opportunities successfully, or do not meet their stakeholders' expectations of their ESG performance, they are likely to experience negative financial impacts. This could manifest as "decreased demand for goods or services, increased cost of capital, governmental fines or taxes, impaired competitiveness in the labor markets, increased insurance costs, and other financial impacts." However, it is uncertain if this is what the ISSB had in mind when drafting IFRS S1. We should closely observe the ISSB's discussion in this matter which hopefully will shed more light.

Investors' needs, are they all equally important?

Draft IFRS S1 states multiple times that the objective of sustainability reporting under IFRS Sustainability Disclosure Standards will be to provide the users of financial statements with the information they need to decide whether to provide resources to an entity.

But there is still uncertainty about whether the standards are aimed at meeting different kinds of investor needs. For instance, ESG investing has grown quickly and is now mainstream. Many investors consider ESG metrics when deciding whether to provide resources to a company. It is not clear whether the draft standard aims to address the needs of this type of investor, meaning that it is also unclear what information needs to be disclosed.

Do the ISSB need to provide more prescriptive guidance?

The ISSB, like the IASB, sets principle-based standards that do not prescribe a specific calculating method, the level of granularity, or practicalities such as how to obtain the data necessary to produce the required disclosures. This is partly why the ISSB was able to write its first two exposure drafts so quickly. Being more prescriptive about methodologies and data sources will be time consuming and complex, as sustainability and climate reporting are relatively new and developing topics.

There is no market agreement on calculation methods for climate and sustainability reporting. But over the past few years, different organizations, industry groups and regulators worldwide have been working on developing these calculation methods. Work has been done on calculating Scope 3 emissions from investment portfolios, and measuring expected losses from natural catastrophes, factoring expected climate change into the equation.

This work has gained momentum recently. The involvement of regulators and standard-setting bodies adds urgency and gravitas to these efforts. An example of such guidance could be the PCAF Global GHG Accounting & Reporting Standard, which is based on, and consistent with the GHG Protocol and aims to address its practical implication to investments of financial institutions. Insurers will have to choose further guidance themselves and decide if applying it will meet the ISSB's requirements. Measuring

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[3] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD678.pdf

GHG emissions from insurance portfolios will be particularly tricky as this topic has been less explored and developed than emissions from the investments.

How will the standards assure inter-company comparability?

By setting a minimum global baseline, the ISSB aims to bring comparability to sustainability reporting. However, the baseline is somewhat undermined by the inclusion of multiple exceptions in both exposure drafts. These allow the replacement of quantitative information with qualitative, when a company is “unable” to provide the former. The ISSB did not use the term “impracticable”, which has been defined and explained in some existing IFRSs setting specific conditions such as the cost of obtaining the information exceeding the benefits of reporting on it. It is not clear if using different terminology was intentional.

In addition, scenario analysis can be replaced with an alternative method when assessing the financial impacts of climate risks and a company’s strategy resilience.

Insurers may be not sure if and when they could use the exceptions mentioned in IFRS S2, without risking incompliance. Given that insurance is usually one of the mostly regulated sectors, it would be safe to assume that possible exceptions may rather apply to some smaller and less sophisticated companies.

Insurers may struggle with gathering the necessary data, and common market practice in measuring and projecting these types of risks is only emerging. Unlike the IASB, the ISSB did not create separate requirements for listed and other high-profile public interest companies and small and medium-sized enterprises.

Are the consequences of the disclosures balanced?

Financial institutions such as banks, asset managers, and insurers will be obliged to provide disclosures on their Scope 3 financed emissions – the emissions from investees in which they hold shares, bonds, and other type of investments. These requirements are part of the industry-specific appendix to IFRS S2.

The appendix does not require financial institutions to report on actions they take to help their investees’ GHG emissions reduction. Financed emissions may often be financial institutions’ biggest emissions category, so reporting on them is important information for investors, to understand the sources of transition risks. It may be also useful to other stakeholders who are not the primary users of the statements, such as customers, employees and regulators. However, requiring that reporting only covers financed emissions and not what actions are being taken to help investees to reduce their emissions can have two potentially negative consequences.

First, it may discourage financial institutions from taking action, as they may expect that their financed emissions will be reduced over time anyway due to investees’ efforts to reduce their own emissions.

Second, financial institutions could choose to reduce their GHG emissions by simply divesting their most carbon-heavy investees. Although in the long term, movement of capital from polluting to cleaner industries is desirable; in the short term, if done quickly and without thought to the wider ramifications, it could have considerable socioeconomic consequences.

The most carbon-heavy investees may be companies from key strategically important sectors, such as energy, transport, and construction. Each of these needs to undergo its own transition to net-zero, but a sudden cut in funding may not only make this more difficult, but could lead to a short-term decrease of the services they provide. This point illustrates the need for balanced, thorough disclosures. Many insurers already report on their engagements with investees to encourage their GHG emission reductions. Even if such disclosures do not become mandatory, it may be an important message to investors.

Conclusion

As climate change continues to worsen, awareness of the urgency of the situation is rising. Governments, regulators, shareholders, and the wider public are increasingly demanding that businesses take action to measure their climate risk exposure and their effect on the environment.

Climate and sustainability reporting requirements are still evolving and it is likely that governments and regulatory bodies will continue to refine them and introduce further standards. Accurately measuring your organization's environmental impact and developing measurable sustainability commitments is essential.

The ISSB's discussions will take place from September 2022 onwards. It is important to monitor their progress and be aware how the decisions may impact your business.

Moody's Analytics has been talking to insurers about these new standards, identifying challenges and how these can be addressed. We can help you to understand your current gaps and plan your implementation. Get in touch to speak to one of our experts.

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