In May/June 2021, Millani conducted its Semi-Annual Sentiment Study of Canadian Institutional Investors, with investors managing assets over $4.4 trillion\(^1\). This study is conducted to understand key trends for environmental, social and governance (ESG) integration and to capture a uniquely Canadian perspective over time.

Given global pressure to advance the quality and coverage of climate-related financial disclosures, along with recent indications that reporting in alignment with Task Force on Climate-Related Financial Disclosures (TCFD) may become mandatory, this sentiment study seeks to provide insights on investors’ needs in the evaluation of climate-related risks and opportunities, using the TCFD as a reference.

This report can be read in conjunction with Millani’s June 2021 publication, “TCFD Disclosure Study: A Canadian Perspective”, in which Millani examined the extent to which the S&P/TSX Composite Index constituents align with the TCFD recommendations. Millani found that only 23% of issuers are currently reporting in alignment with these recommendations. This implies that most Canadian issuers are exposed to the risk of diminishing their access to capital and, by extension, limiting investors’ access to their returns.

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1. Approximate amount calculated from public sources.

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Sustainable investing attracts record flows

In May 2020, during the height of the COVID-19 pandemic, Millani conducted a sentiment study with Canada’s largest institutional investors to gather their views on the impact of COVID-19 on ESG practices and sustainable finance. At the time, 74% of the interviewees believed that the pandemic would have a positive impact on sustainable investing. They were right.

Over the last year, investments in sustainable funds have more than doubled since the pandemic-related market dip. In the first quarter of 2021, sustainable funds drew a record global inflow of US $185.3 billion, leading to a record-breaking total of US$1.6 trillion in sustainable funds worldwide2.

The accelerating inflow of capital to sustainable funds implies that good ESG performance and disclosure can translate to better access to capital and more favorable financing terms. As well, the trends indicate that the focus of asset owners is shifting from traditional finance towards sustainable finance.

An accelerated pace of change

When asked what was most surprising in the field of sustainable finance over the last six months, most respondents referred to the accelerating pace of change around ESG integration – including regulations, fund flows, and net zero commitments. As the financial impacts of managing ESG issues become clearer, governments and investors are increasingly focused on the breadth and depth of ESG disclosures.

In early June, the G7 nations endorsed mandatory TCFD-aligned financial disclosures aimed at reinforcing government efforts to meet net zero commitments3. Support for mandatory disclosures may be extended by G20 countries as well4.

When asked in June about the pace of regulatory change and what should be expected of governments over the next few years, Mark Carney, UN Special Envoy on Climate Action and Finance, advocated for mid-term policy targets and frequent disclosure of progress towards those goals, to provide clear signals for companies and investors on how best to allocate capital. Notably, Carney expects that the pace of regulatory change will remain constant or increase in the foreseeable future5.

Canadian investors are also surprised by the pace at which US and Canadian governments are adopting policies on ESG and climate change. At the end of May, President Biden signed the Executive Order on Climate-Related Financial Risks6, which requires the advancement of clear and comparable disclosures of climate-related risks of different federal agencies and their regulated entities. Notably, the Financial Stability Oversight Council (FSOC), chaired by US Secretary of the Treasury Janet Yellen, is directed to provide recommendations on how US federal financial regulators can assess and manage climate-related risks.

In mid-June 2021, the US House of Representatives passed legislation that would require public companies to report on ESG topics. If approved by the Senate, listed entities will be required to disclose specific ESG metrics and how they are integrated into the long-term strategy of the firm, including pay equity, executive compensation, tax liabilities, political expenditures, and climate risks7.

In January 2021, the Ontario Capital Markets Modernization Taskforce recommended that Canadian entities should be mandated to align with the TCFD recommendations. This was supported by Canada’s 2021 federal budget which included new requirements for Canada’s Crown corporations to disclose climate-related information in alignment with the TCFD recommendations. In May 2021, the Sustainable Finance Action Council was launched, with the aim of advancing the recommendations of Canada’s Expert Panel on Sustainable Finance, which include the adoption of TCFD for Canadian corporations and financial institutions.

4. Reuters, “G20 to endorse deal on global minimum corporate tax - draft”, June 22, 2021
There is clear and growing support for the TCFD recommendations in jurisdictions around the world. However, Millani’s June 2021 publication, “TCFD Disclosure Study: A Canadian Perspective”, indicates that only 23% of Canadian issuers currently report in alignment with the TCFD, led by the Extractives & Minerals Processing and Infrastructure sectors. This implies that there are many issuers in Canada who are facing the need to prepare their first climate report.

What’s expected from a first-time climate reporter?

When asked for advice for first-time climate reporters, many suggested to start with what can be reported for now, and to think about how the reporting journey can be iterative and progressive. Many interviewees noted that their own stakeholders expect them to publish climate reports as well and that they were empathetic to the challenges of TCFD reporting for corporate issuers.

“Don’t let perfection be the enemy. Sometimes less is more, especially with first time responders.”
– Asset Owner

Millani asked interviewees to provide issuers with some additional insights on their thoughts and expectations on climate reporting. The highlights of their responses are provided below.

Should issuers disclose on Scope 1, 2 or 3 GHG emissions?

Scope 1 emissions are direct greenhouse (GHG) emissions from sources controlled or owned by an organization. Scope 2 emissions are indirect GHG emissions associated with the purchase of electricity, steam, heating, or cooling. All respondents indicated that they are reviewing and assessing both Scope 1 & 2 emissions.

“Scope 1 & 2 are now table stakes.”
– Asset Owner

Scope 3 GHG emissions are indirect emissions that occur in an organization’s value chain, including both upstream (e.g., vendors) and downstream (e.g., product use) emissions. Here, the investor’s views were more ambivalent. Most recognized the value of this metric and why it should be taken into consideration. Although a number of investors questioned the current methodology for the calculation of Scope 3 emissions and the reliability of data currently being published, there was still strong desire to have issuers work towards disclosing Scope 3 emissions.

“Scope 3 is most important, as companies have decision power and can control a full range of elements in their value chain.”
– Asset Owner

According to data compiled by the Carbon Disclosure Project (CDP), a company’s supply chain emissions are typically 5.5 times its operational emissions. Given the significance of Scope 3 emissions, some investors indicated that with the growing number of net zero emission targets by organizations globally, Scope 3 emissions will be increasingly requested and accounted for. Respondents believed that one of the most surprising trends of the 2021 proxy season – already full of surprises - was the level of support for climate-related proposals, including shareholder approval of setting Scope 3 emission targets for Chevron9 and ConocoPhillips10.

8. CDP, “CDP Supply Chain: Changing the Chain”, 2020
9. Reuters, “Chevron investors back proposal for more emissions cuts”, May 26, 2021
Should issuers disclose on absolute emissions intensity?

“We prefer absolute emissions, because we can calculate our own intensity measures.”
– Asset Owner

When evaluating emissions, most investors desired disclosure of both absolute emissions and emissions intensity, because each data type can be used for different purposes. Absolute emissions refer to the total quantity of GHG emissions being emitted – useful for evaluation of progress towards long-term targets – whereas emission intensity normalizes the absolute emissions over some unit of economic output, allowing for a comparable assessment against peers in the shorter term.

“We are assessing both, absolute and intensity, as we are interested in understanding the underlying narratives of each metric.”
– Asset Owner

Are disclosures on scenario analysis meeting investors needs?

When asked about scenario analysis, most participants agreed that pertinent information used to assess the impact of climate change on company financials is often missing, making the exercise less valuable than originally anticipated. It was noted that large companies have more resources than smaller ones, for whom the process can be burdensome, complicated and time consuming. Crucially, investors would like to see more granular information on how the company’s capital expenditures are linked to the outcomes of scenario analysis.
Understandably, there are some reservations by issuers to disclose on these scenarios, given the potential legal consequences of forward-looking statements. As noted in the final report of the Canada Expert Panel on Sustainable Finance, a potential solution to this issue is a safe harbor provision to protect and encourage companies for more authentic climate-related disclosures11. This solution was also suggested by the head of the Securities Exchange Commission (SEC), Elad Roisman, while addressing challenges in moving to mandatory ESG disclosures12.

“TCFD scenario planning shows us how viable their business will be in a future towards net zero and that they’re taking it seriously, and integrating it into their future business strategy.”
– Asset Manager

Net zero commitments

Since the beginning of 2021, there have been many announcements of net zero targets by public issuers. When asked about their reaction to this trend, our participants indicated that net zero commitments are being viewed as a positive development. However, what investors desire most are interim targets that are linked to the company strategy. Some respondents also indicated that they welcome the opportunity to engage with management and to discuss plans to meet these targets.

“Net zero targets are nice to see, but in isolation, not sufficient.”
– Asset Manager

Transition and physical risks

Investors are moving their focus away from just transition risks and are assessing physical risks too. Transition risks imply the risk of moving towards a lower-carbon economy, while physical risks refer to the potential costs associated with climate change. An emerging concern by some respondents was that there is not enough focus on physical risks, and they would like to see a shift in focus.

“Companies are underestimating the growing importance of climate change disclosure in the next 5 years. Their reputation and credibility are on the line.”
– Asset Owner

Climate-linked executive compensation

Most of the interviewees encourage disclosing a link between executive compensation and climate-related targets. Many suggested that they would find a link meaningful if targets were linked to longer-term bonuses, especially if targets are financially material for the business. Although most agreed that it would demonstrate accountability, some questioned the impact of such a measure, given the complexity of executive compensation schemes.

“It would be interesting to see how compensation ties to a 2025 or 2030 target. The link needs to be substantive enough so that executives feel it.”
– Asset Owner

Conclusion

Since the beginning of the year, the pace and scale of progress in the climate and ESG space has surprised many in the investor community. As the financial impacts of these topics becomes clearer, the pace is likely to accelerate.

“The investor community is mindful that ESG reporting can be burdensome. When referring to TCFD-aligned reporting, most respondents advised to start with the most critical aspects and demonstrate commitment to improve, rather than trying to meet all recommendations. A well-articulated strategy can be instrumental in successfully managing the narrative directed to stakeholders.

“Improving disclosure on the location of the assets is going to be increasingly critical, as the progress of the economic transition is very slow.”
– Asset Owner

12. SEC Commissioner Elad L. Roisman, “Putting the Electric Cart before the Horse: Addressing Inevitable Costs of a New ESG Disclosure Regime”, June 3, 2021
Targets alone are difficult to assess. However, targets backed by a clear strategy, interim milestones, and a pathway towards net zero brings credibility to the commitments.

“Don't be overly concerned about whether you can tick all of the boxes of the 11 recommendations, it's about transparency and sharing perspectives on the issues.”

– Asset Manager

As noted in Millani’s 2021 MarketTrends report\(^{13}\), mandatory ESG and climate-related disclosures are around the corner. Given growing market needs and expectations, failure to disclose on material ESG and climate-related issues could expose corporate issues to reduced, or more costly, access to capital. To avoid this risk, issuers should begin now to understand their ESG issues and start their ESG disclosure journey.

If you would like more information on this topic, please send an email to info@millani.ca or call 514-507-8010.


Contributors

Thank you to our contributors who took the time to provide their insights on TCFD-aligned disclosures. Our contributors represent 23 of Canada’s largest institutional investors, some of which are listed below.

About Millani

Millani provides advisory services on ESG integration to both investors and companies. For the past 13 years, Millani has become the partner of choice for institutional investors. By providing advisory services on integrating material ESG issues into their investment strategies and decision-making processes, we help our clients reduce risks, increase returns, and create value. Millani is also leveraging this expertise and its experience in ESG consulting to help reporting issuers improve their ESG disclosure to financial stakeholders and optimize their market value.

For more information, contact us at: info@millani.ca or visit our website: www.millani.ca