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Science-Based Climate Metrics in corporate disclosure of climate related risks

The CSR Directive the X-Degree Compatibility ("XDC")

In late 2016 an amendment to the Directive on non-Financial Disclosures was enacted by the EU Parliament, requiring large undertakings disclose material non-financial information. Including considerations of environmental, social and governance factors that might help provide a better understanding of companies' development, performance, position and impact of their activity.

The directive 2014/95/EU on the disclosure of non-financial and diversity information by certain large undertakings has already been enacted into German legislation as well as into most European countries' regulations.

This directive intends to get companies disclosing their (I) sustainability strategy. As well as (II) material risks linked to the entities operations, especially those which are very likely to have a material adverse effect on the matters on which disclosure is required. In addition, to be disclosed is the (III) management of such risks by the corporations and (IV) non-financial key performance indicators relevant to the particular business.

Amongst the requirements of this directive, we find requests for disclosure of green house gases, renewable and non-renewable energy and risks which might affect business activities, which are to include climate related risks and risks derived from the companies´ contribution to climate change.

This means that there is a legal obligation on companies to disclose risks associated with climate change as well as to disclose their strategy for responding to them in a way that is sufficient for enabling a better understanding of the company´s development, performance, position and impact.

The failure to disclose non-financial information in a mode that is complaint with legal requirements could be the basis for legal challenges.

- Direct affectation: directors and boards could face personal liability, fines and regulatory interventions as a result from inappropriate or insufficient disclosures.

Besides the potential legal challenges that can arise, we see 3 hurdles resulting from the requirements established by the CSR Directive:

1. Materiality: determination of climate as a material risk factor.

2. Scope and detail: disclosures requirements under this Directive can be interpreted as been broad and general, but when grasping the intention of it, disclosures have to provide enough information as to allow its recipients to contemplate potential material risks derived from the information disclosed.

3. Forward-looking disclosures: The law requires risks to be anticipated, thus for forward-looking information, as the basis for expected risks, to be disclosed. Companies claim to anticipate the risks of climate change. Saying they do this this by self-imposed climate goals.

Though legally required risk forecasts, however, are difficult to deduce from such passages. Since this does not really constitute forward-looking information.

The XDC metric can offer a response to these hurdles.

The XDC is a science-based climate metric, which establishes how many degrees the earth would warm up to by 2050 should all companies be as emission intensive and have the same economic output as the company in question.

Example: Smiles Ltd.'s XDC is 2.3°C; the sector specific average is 2.5°C

The way in which the XDC can provide guidance or response to previously mentioned hurdles is firstly by recurring to the <u>Climate Materiality Test:</u>

1. In calculating the XDC of a certain company, one is able to determine the specific contribution of a company to climate change, seeing that Smiles Ltd.´s performance, contributes to raising global temperatures to 2.3 °C degrees, we can determine with a high degree of likeability that climate is a material[1] factor and should therefore, be reported.

2. After determining the materiality of climate change, the XDC can also provide guidance on the scope and detail of information to be provided. The XDC can provide information relating to the contribution, impact and exposure of a Smiles Ltd. to and from climate change. It can specifically:

    - Indicate the level of exposure to transition risks
    - Provide direct information of the impact of the company on the environment
    - Describes the company's level of decoupling of economic output and emissions today and in the future
    - Allow for comparability to relevant sector-specific average and target XDC-values

3. In calculating their XDC, companies are able to grasp the risk derived from their contribution to climate change and effectively disclose the future impacts and exposure their contribution leads to.

Besides allowing for a thorough assessment and disclosure of the impacts of climate change, in reporting their XDC, companies would comply with disclosure requirements demanding environmental factors be reported on, specifically when referring to climate as an environmental matter, mandatory under Section 289c (3) and (4) HGB. Which also calls for disclosure of risks derived from a company´s standing including an appropriate perspective on short, medium and long-term principal risks.

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[1] Entities operating above the 2 °C threshold are subject to the regulatory, litigation, market and financial risks that will arise due to lack of alignment with 2 °C oriented policies. We see regulations are progressively coming into effect. We are seeing the increase of litigation against companies for inappropriate disclosure of climate risks, litigation for excessive contributions is also going up, as are transition and market risks are also increasing. All of which will have an impact on earnings; from that stand point, they are also material.

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Companies are expected to explain how principal risks may affect their business model, operations, financial performance and the impact of their activities. Under these requirements, companies are expected to disclose:

Significant risks from own business activities 289c (3) and significant risks from business relationships, products and services 289c (4):

By having a certain XDC, a company might be exposed to a substantial amount of risk, from a political, regulatory and financial perspective.

- Political: seeing that the EU is one of the biggest supporters for keeping global temperatures under 2 °C, all efforts by players within the EU must be in line with this policy at the expense of seeing direct government pressure materializing. This could happen by cut of subsidies, price on carbon, rejecting possibilities for renewal of operating licenses, as well as increased likelihood of litigation by citizens and state entities (Mid-Long Term). In having a precise number clarifying the precise exposure derived from an individually quantified contribution, companies will be able to sense and assess which of their business activities, relationships and products will be threatened first and with what degree of severity.
- Regulatory: seeing that political decisions will materialize eventually via regulation will make the requirements more formal and obligations to adapt to operational requirements stricter (energy efficiency, quota of renewables, carbon tax). (Mid-Long Term)
- Financial: by calculating its XDC, the company will be able to assess whether its current and future investments will constitute risks and quantify the amount of risks they might represent. The risk being derived by the level of alignment or lack of with the company´s climate strategy.

The XDC can serve to provide sound disclosure on climate as a risk factor in a way that is compliant with existing regulation. In calculating and disclosing and XDC the entity is able to demonstrate the sound understanding that climate might have for a company, a high level of due diligence on its reporting and simultaneously work with a number that is useful for climate management and financial decisions.

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