

Article 173: Overview of climate-related financial disclosure after two years of implementation

Paris,
December 2018

Authors : Julie **Evain** | Michel **Cardona** | Morgane **Nicol**

In 2015, article 173-VI of the French Energy Transition for Green Growth Act set a global precedent by requiring investors **to be transparent on the climate impacts of their investments**.

Why was article 173-VI introduced? The legislator had two objectives:

- **Making investors more aware of the emissions generated by their investments** and of the **associated risks**, to ensure they gradually **align their portfolios with a 2 degree pathway**;
- Ensuring transparency on climate action by investors, to enable the **public authorities, NGOs, think tanks** and, more generally, **civil society** to use this reporting process to **put pressure on investors**.

After two years of investor climate reporting, covering their activities in 2016 and 2017, what lessons can be drawn from article 173-VI? This is the question to be answered by the French Ministry of Finance and the Ministry for the Ecological and Inclusive Transition, with the upcoming review of implementation for this mechanism.

In this policy brief, and based on three ongoing research projects on climate finance¹, I4CE takes stock of the application of article 173-VI and of its implications for the evolution of climate reporting practices and investment management. Drawing on this, I4CE makes recommendations to improve its impact at the French level. It is hoped that these recommendations will also be useful in the debate at the European Union level, while negotiations on a future “European article 173” are underway.

¹ The ongoing projects are: a report in collaboration with WWF on the application of article 173 by French insurers; several studies on physical risks in the context of the European ClimINVEST project, for which a series of interviews were conducted with key financial actors; and the Re-imagining Disclosure project in collaboration with CDP.

With the exception of a small, committed group, this second year of application of article 173 by insurers has **not produced the expected changes** in reporting practices. Insurers are supposed to be at the forefront of climate awareness, yet few of them report on all three of the dimensions set out in the text (carbon footprint, climate risks and contribution to climate change mitigation). Some of the metrics are progressing, such as portfolio alignment with a 2 degree pathway or the green share of portfolios. But in general, the **level of appropriation of the issues and degree of transparency** unfortunately remain **unsatisfactory**. This exercise sometimes tends to shift towards a **compliance report**, straying from the initial objectives of the text.

Recommendations at the French level

The public authorities should encourage actors to report on the three dimensions set out in article 173.

By **modifying the decree implementing article 173** or publishing **guidelines**, the public authorities should clarify their expectations of investors regarding: **the objectives of the different indicators proposed; the transparency of the analysis process and of results; the analysis of scenarios; elements of governance and strategy; and the “comply or explain” approach**.

The research and development ecosystem must also be supported by the public authorities, in the form of calls for projects or competitions, in order to produce new or better methodologies. In particular, approaches that foster open, understandable methodologies should be supported, to accompany investors in their appropriation of climate issues.

Recommendations at the EU level

With its status as a pioneer, France can drive an ambitious position that is informed by its national experience: a European reporting process that is at least as ambitious as article 173-VI. France could support changes to the guidelines for the directive on non-financial reporting, along the same lines as the recommendations made for France.

It should also support the take-up of TCFD recommendations, which implies extending the process to include other investors (banks, etc.) not covered by the French text, other segments of financial activity (loans, insurance, etc.) and the analysis of different scenarios.

I. High expectations, but a disappointing year in 2018

A. Summary of obligations under article 173-VI and general observations

The decree implementing article 173-VI recommends that investors report on three dimensions:

- **Measuring the carbon footprint of their investment portfolio:** this indicator calculates the greenhouse gas emissions generated by investments;
- **Analysing their exposure to transition risks and to physical risks:** these are the potential financial impacts linked to the transition to low-carbon economies and those linked to physical impacts (extreme climate events, sea-level rise, etc.);
- **Measuring their contribution to climate change mitigation:** this means measuring portfolio alignment with a 2 degree pathway and calculating the green share (financing the transition) and brown share (contrary to the transition) of portfolios.

This obligation has resulted in the development of indicators to measure these three dimensions. Behind each indicator are different possible methodologies, and many are still in the development stage.

Although reporting is compulsory, article 173 is nevertheless built around a comply or explain approach. This means that any financial actor that is unable to comply with one of the obligations must explain their reasons for failing to disclose certain information.

To assess the implementation of article 173, I4CE, in collaboration with WWF, focused on French insurers. Indeed, through their core business, which puts them in the front line

of the physical impacts of climate change², these actors are supposed to be some of the most sensitive to these issues.

This study highlights the fact that reporting by insurers does not cover all of the dimensions set out in article 173 and its decree. Moreover, when indicators are calculated, certain information required to correctly understand and compare them is often missing (scope of the calculation, methodology, results, etc.). Finally, the comply or explain approach is not widely applied, and when information is missing, its absence is not systematically justified.

We have not observed any stabilisation or standardisation of reporting methods. The goal of article 173 was **to identify a range of reporting practices before an appropriate standard emerged**.

The first objective has been met, with a **plethora of indicators and methodologies**. However, for all of the indicators, with the exception of the carbon footprint, the calculation methodologies are still incomplete and need to be improved.

B. Stock take on the three reporting dimensions

As regards the carbon footprint of portfolios, this is calculated by almost all insurers, although there are still problems of transparency and methodology. New practices are emerging to enable a shift towards more meaningful calculations, especially by including Scope 3 (indirect non-energy emissions linked to the manufacturing, distribution and recycling of products). But this indicator only provides information on past emissions, and therefore says nothing about the climate pathway of portfolios.

However, analysis of exposure to transition risks and to physical risks is still neglected, especially where the latter is concerned. Most analyses are based on incomplete assumptions, reducing the transition risks to the carbon price (without including risks of changes to business models, technology, etc), and reducing

² Fédération Française des Assurances, "Climate risks: Impact on natural hazards insurance between now and 2040."

BOX 1. ANALYSIS OF PHYSICAL RISKS

Due to a lack of understanding of climate change impact chains, analyses of the "physical" risks are either **missing, still fragmented**, or conclude **that there are no physical risks** for investors, despite warnings to the contrary by the regulator. Among the minority of investors that do conduct such analyses, these only cover part of the portfolio – mainly property and infrastructure – or a limited number of sectors or hazards, such as flood risk. The investment horizons analysed are not always relevant, and many analyses are based on the **extrapolation of past data**, without taking account of future changes in the frequency and intensity of physical hazards.

There are two reasons for these incomplete analyses: the first is a **lack of general understanding of climate change**, in terms of its processes and impacts; the second is that the **calculation methods developed by external service providers are not yet fully developed** and remain fragmented.

Moreover, the majority of investors that have conducted a physical risk analysis used external service providers, whether or not this relationship is explicitly mentioned. This is often reflected in their reports by a lack of transparency on methodologies, which undermines the analysis or even the **credibility of the results**.

Concerning the indicator on exposure to physical risks, article 173-VI does not appear to have acted as a catalyst for analysis, and is still too often seen as a compliance exercise, in which the indicators mention results that are not necessarily relevant, but allow financial actors to consider themselves as complying with the decree.

To measure the contribution to climate change mitigation, investors have developed indicators such as the measurement of alignment with a 2 degree pathway and calculations of the green and brown shares of portfolios. Article 173 has driven the development of these new metrics and of innovation surrounding the methodologies. Concerning alignment with a 2 degree pathway in particular, special efforts have been made to calculate this indicator, and a number of different methodologies have been developed. However, these have not yet arrived at maturity, and it would be premature to recommend one in particular at this stage.

* Villeroy de Galhau, "La Finance Verte – Une Nouvelle Frontière Pour Le XXI^e Siècle."

the physical risks to extreme climate events (without including chronic events such as sea level rise or desertification). Moreover, few insurers use analyses based on scenarios, even though it is crucial to analyse the risks and to prepare for different global warming configurations (2, 4, 6 degrees, etc.) and technological choices.

C. A lack of transparency on methodologies and results

To understand the result of each indicator, **additional information** is needed: the **scope** of investments for which an indicator is calculated, the **methodology** used to arrive at this result, the **source of data** used and the **references** of any **climate scenarios** that have enabled the prospective assessments. All of this information helps to put the result and its credibility into perspective.

For example, a portfolio alignment analysis conducted for a very small portion of investments is not representative of an investor's practices.

However, with the exception of the carbon footprint, these different types of information that help to understand the calculation process for an indicator are not always included in 173 reports. **The level of transparency, especially on methodologies, but also on the actual publication of results, remains unsatisfactory.**

D. A poor understanding of analyses conducted by service providers is a barrier to their integration into company strategy

Of the panel analysed during the study on insurers, **the majority delegate a large part of the drafting of their report to an external service provider.** Although these providers play a key role in the climate reporting ecosystem, which explains their presence, the use of their analyses and methodologies should not compromise the internal discussions that the reporting exercise is intended to stimulate.

However, we see that companies often tend to rely heavily on service providers, which sometimes produce all of the reports published. This is detrimental to the appropriation of analyses and the necessary examination of the relevance of the indicators and underlying assumptions. Furthermore, this lack of appropriation of the metrics, methodologies and their results means that **no real changes are made to management practices**, which was one of the objectives of article 173-VI.

This raises concerns that all too often climate reporting shifts towards a compliance exercise, straying from the legislator's initial objective, which was to increase financial flows for the low carbon transition.

FIGURE 1. SUMMARY OF INSURERS' REPORTING PRACTICES BY INDICATOR

This table shows the elements of analysis that are made transparent for each of the new indicators.

Prospective indicators	Transition risks					Physical risks					Green/ brown share		Alignment on a 2 degrees pathway				
	Scope	Methodology	Results	Scenarios	Service provider	Scope	Methodology	Results	Scenarios	Service provider	Green share	Brown share	Scope	Methodology	Results	Service provider	Scenarios
ACM Assurances - Crédit mutuel																	
AG2R						Physical risks not mentioned											
ALLIANZ																	
Aviva																	
AXA																	
BNP Paribas Cardif	Transition risks not mentioned					Physical risks not mentioned											
CNP Assurances																	
Covéa																	
Crédit Agricole Assurances	Transition risks not mentioned					Physical risks not mentioned											
Generali France	Transition risks not mentioned																
Groupama						Physical risks not mentioned							2 degree alignment not mentioned				
HSBC France	Transition risks not mentioned					Physical risks not mentioned							2 degree alignment not mentioned				
MACIF						Physical risks not mentioned											
MACSF						Physical risks not mentioned											
Natixis Assurances						Physical risks not mentioned											
Société Générale Sogécap						Physical risks not mentioned							2 degree alignment not mentioned				
Swiss Life	Transition risks not mentioned					Physical risks not mentioned							2 degree alignment not mentioned				

Key: ■ Presence of data ■ Absence of data

II. Recommendations for better national implementation and an ambitious European position

A. At the French level, article 173-VI can be further clarified and the actors need greater support

Investors do not currently cover all of the compulsory approaches in their reporting: carbon footprint, climate risks and contribution to climate change mitigation. If the public authorities choose to stick with a comply or explain approach, there is a strong need for incentives for investors and for clarification of what is expected.

To ensure a better application of article 173-VI, an **approach entailing support** for key actors is also needed, to increase their understanding of the issues and to encourage them to report on all dimensions. This support should be established by the public authorities and regulators during their bilateral and multilateral interviews with investors.

The other problems identified, such as the lack of understanding of indicators, the lack of transparency on the analysis process and the results, and the broader appropriation of climate issues by the financial sector, all point to the possibility of changing the mechanism.

Two solutions are possible: either modifying the decree, or developing guidelines to accompany the article, in connection with the research conducted by the Technical Expert Group on Sustainable Finance³ to clarify the following elements:

- **The objective of each indicator** and what it seeks to measure, in order to avoid confusion and the use of irrelevant methodologies;
- **The different elements of the analysis process and the results:** for each indicator, transparency must be ensured for the scope calculated, the methodology, the results, and the use of one or more service providers for the analysis;
- **Precisions on the comply or explain approach:** in case of missing information on an indicator or on elements enabling its calculation (methodology, results, etc.), the company must explain the reasons for its choice (for example, no data, no methods, no materiality, etc.);
- **Elements on governance and strategy**, as recommended by the TCFD, in order to understand how climate risks are taken into account by financial companies, and how these challenges impact portfolio management;
- **Elements on the analysis of scenarios**, also recommended by the TCFD: exposure to risks must be determined by testing different possible scenarios.

Finally, to tackle the challenge of developing new indicators, the research and development ecosystem must also be supported by the public authorities, in the form of calls for projects or competitions, in order to produce new or better methodologies. In particular, approaches that foster open, understandable methodologies should be supported, to accompany investors in their appropriation of climate issues.

3 https://ec.europa.eu/info/publications/sustainable-finance-technical-expert-group_en

BOX 2. THE TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES

Three years after the introduction of article 173-VI, the context has changed: investor climate reporting now has a **strong international dynamic** thanks to the work of the Task Force on Climate-related Financial Disclosures* (TCFD) and could be **introduced into the guidelines for the European directive** on non-financial reporting**.

The TCFD, chaired by Michael Bloomberg and mandated by the FSB, submitted its research in 2017. It recommends that financial and non-financial actors report on financial elements linked to the climate around four different areas: their governance, their strategy, their management of climate risks, and the indicators and objectives used. It also recommends that companies adopt a prospective approach, establishing strategies that are aligned with low-carbon scenarios.

* TCFD, "Final Report - Recommendations of the Task Force on Climate-Related Financial Disclosures."

** European Commission action plan on financing sustainable growth.

B. At the European level, EU guidelines must be at least as ambitious as article 173 and should take up the TCFD recommendations

Further to work by the Expert Group on Sustainable Finance⁴, the Commission made a proposal in its action plan⁵ for the revision of the directive on non-financial reporting. With its status as a pioneer, France can drive an ambitious position that is informed by its national experience: **a European reporting process that is at least as ambitious as article 173-VI**. In view of current debates, it is important that this European reporting process includes a **measurement of the contribution of portfolios to the objectives of the transition, in order to produce prospective indicators**.

The directive on non-financial reporting includes **European guidelines**, which could be modified in line with the recommendations made at the French level.

To do so, it could draw on the **TCFD recommendations**, which advocate, for example, the **analysis of different scenarios and the inclusion of information on climate risk strategy and governance**.

Extending the process to actors other than investors and to other segments of financial activity (loans, insurance), also recommended by the TCFD, would be the opportunity to increase the number of financial actors concerned by this approach, which would facilitate the production and collection of the necessary data.

However, although the TCFD recommends a voluntary process, French experience calls instead for a **regulatory approach**, which is key in involving all investors. At the European level, it seems wise to adopt a **comply or explain** type mechanism, but supplemented by the intervention of monitoring authorities to verify the implementation of the text. As suggested by a Commission communication⁶, ESMA could play this role along with the national authorities.

4 HLEG, "Financing a Sustainable European Economy."

5 European Commission action plan on financing sustainable growth.

6 European Commission, Reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment.