

To: External Reporting Board, climate@xrb.govt.nz

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Re: Climate-related Risk Disclosure Framework

General Background

The External Reporting Board (XRB) has recently published the exposure drafts (EDs) of Aotearoa New Zealand Climate Standards regarding the Climate-related Disclosures Framework. As part of the due process for developing standards, the consultation document seeks feedback from stakeholders and the public.

This submission responds to the call for “constructive and solutions-focused feedback” (consultation document, p. 4). It focuses on Aotearoa New Zealand Climate Standard 1 (“Climate-related Disclosures”; ED NZ CS 1) and Climate Standard 3 (“General Requirements for Climate-related Disclosures”; ED NZ CS 3).

This submission highlights six issues and makes corresponding recommendations. These issues and suggestions can be categorised in the following manner:

- Recommendations 1.1-1.2 respond to consultation question 2. Specifically, we call to expand the definition of “primary users” and better account for the participation and inclusion of stakeholders, customers, individuals, and organisations.
- Recommendations 2-5 seek to improve the design of the proposed disclosures. In summary, we opine that the proposed framework creates ambiguities and accords too much discretion and leeway to disclosing entities. We submit that the framework should provide further clarity and certainty. In doing so, recommendations 2-5 largely respond to consultation questions 1.b, 1.c. and 5.
- Recommendation 6 strives to better the regulatory framework. It mainly suggests a more gradual and temporal approach that avoids regulatory inertia. It seeks to guarantee the framework is adaptive, periodically assessed and regularly re-examined. While general in nature, this recommendation relates, in a way, to consultation questions 1-2 and 5-6.

1. Primary Users

- 1.1 The framework attempts to ensure that climate reporting entities (CREs) disclose information that primary users find useful. Accordingly, ED NZ CS 1 states that “the objective of this [draft] Standard is to enable primary users to assess the merits of how entities are considering those risks and opportunities, and then make decisions based on these assessments” (p. 6; see also the definition of “climate related disclosures”, p. 14).
- 1.2 Correspondingly, one of the major issues the consultation document raises is whether the climate standard will meet the need of said primary users.
- 1.3 The proposed standards define ‘primary users’ as existing and potential investors, lenders, and other creditors (ED NZ CS 1, p. 13).
- 1.4 However, the definition does not include employees, customers, or taxpayers.

- 1.5 The Basis for Conclusions on [draft] NZ CS 3 (BC25) notes the previous calls to widen the definition of primary users. Notwithstanding these calls, the XRB Board concluded that since the framework addresses entities (or products) that can be invested in, there is “a strong rationale to provide a tightly focused primary users definition that emphasises investor needs, rather than broadening it to other users”.
- 1.6 With due respect, we submit that focusing on a relatively narrow spectrum of primary users undermines the disclosures’ potential. Including employees, customers, and taxpayers as ‘primary users’ would make the disclosures more powerful. Thus, expanding the definition of primary users will further incentivise entities to comply with the proposed framework and advance its goals. Slightly restated, the efficacy of the disclosure regime will increase if the definition of primary users is clearer and more encompassing.
- 1.7 The XRB Board seems to have implicitly recognised the weakness of the current narrow definition of primary users by including ‘potential investors’. In principle, potential investors could be broadly conceived and encompass almost everyone. However, this interpretation is incongruent with the intention to “provide a tightly focused primary user definition” (ED NZ CS 3, BC25).
- 1.8 Notably, the justification for employing a ‘focused definition’ of primary users relies on the scope of entities included in the disclosure regime. We disagree with this logic, which leaps from the ‘scope question’ to the ‘audience/user question’. It is perfectly logical to limit the scope under one criterion (especially as that limit is widely perceived to be temporarily narrowly defined) and target the disclosure differently.
- 1.9 Moreover, the XRB Board acknowledges that the current definition of primary users “may warrant a change” if the scope of entities changes (ED NZ CS 3 BC26). Changing the definition of ‘primary users’ ex-post will force reporting entities to re-design their disclosures. Such a change, of course, may contradict the consistency and comparability principles.
- 1.10 Additionally, the XRB Board acknowledges that “different entities may have primary users with different levels of sophistication” (ED NZ CS 3 BC28). This difference arises because of the narrow definition of primary users. This difference, again, harms the principles of comparability and consistency. It entails that different CREs will report differently.
- 1.11 Furthermore, a modern conception of the firm focuses on *stakeholders* rather than merely *shareholders* (aka ‘stakeholder capitalism’). This is significant since shareholders consider a shorter time horizon than stakeholders – a term that includes employees and customers. Often, shareholders will not have the broader social and community interest in mind. Rather, shareholders will mostly (or only) care about one narrow dimension of the firm’s impact: profits.
- 1.12 Indeed, the EU recognises the importance of this matter in its “New guidelines on reporting climate-related information” (2019). These disclosures have two primary

audiences for which materiality needs to be assessed (“double materiality”). While the first audience is financial (shareholders only), the second includes environmental and social audiences (concerning stakeholders more broadly).

- 1.13 In sum, the current definition of primary users in the NZ guidelines is too narrow, too limiting, and may result in future inconsistencies and incomparability. It also does not align with emerging international standards.¹

Recommendation 1.1: *Include stakeholders, customers, taxpayers, consumer organisations, etc., as “primary users” and disclosure recipients.*

Recommendation 1.2: *Increase the efforts to proactively seek consumers’/citizens’ input by encouraging relevant organisations, academics, and experts to share their perspectives.*

2. Fair Representation

- 2.1 Fair presentation is the “overarching principle” of the proposed framework. As the consultation document puts it (p. 20), “There is a presumption that Aotearoa New Zealand Climate Standards will result in climate-related disclosures being presented fairly” (see also ED NZ CS 3, paragraphs 1-2 and BC6).
- 2.2 At the same time, the consultation paper (p. 23) queries whether the “draft Climate Standards are clear and unambiguous in terms of the information to be disclosed”.
- 2.3 There is an inherent tension in using fairness as the overarching principle on the one hand and aspiring to design an unambiguous framework on the other. The term fairness (or fair) is a notoriously ambiguous legal norm, and the framework does not offer any concretisation of this norm.
- 2.4 CREs will likely interpret vague legal norms to align with their interests and behaviour.² This may emasculate the disclosures’ impact and create inconsistencies, uncertainties, and disputes.

Recommendation 2: *Supplement the “fair presentation” standard with more concrete and specific rules to provide further guidance, clarity, and certainty. Some illustrations follow.*

¹ Admittedly, the SEC disclosure document contains a narrower conception of primary users in comparison to the EU (that is, one that is more aligned with the XRB’s proposed definition). However, this is so since the SEC’s mandate is narrower (“The U. S. Securities and Exchange Commission (SEC) has a three-part mission: (1) Protect investors; (2) Maintain fair, orderly, and efficient markets; and (3) Facilitate capital formation.”). As the mandate for the NZ disclosures came from parliament, we believe it should encompass a wider target audience, similar to the EU’s Double Materiality discussed in paragraph 1.8.

² This is not to argue that firms will necessarily or always do so intentionally or in bad faith. Rather, bounded ethicality may lead many firms to genuinely believe they are doing the right thing. For a broad discussion of bounded ethicality and its implication see Yuval Feldman, *The Law of Good People: Challenging States’ Ability to Regulate Human Behavior* (Cambridge University Press, 2018).

3. Understandability and Readability

- 3.1 ED NZ CS 3 defines “understandability” as information presentation that is clear and concise (p. 8, Table 2). It calls CREs to balance the information needs of sophisticated and less sophisticated users.
- 3.2 More concretely, ED NZ CS 3 (p. 8, Table 2) suggests employing “tables, graphs, or diagrams” to make disclosures understandable. To further promote understandability, ED NZ CS 3 also states that terms “should be explained or defined for a proper understanding by primary users.”
- 3.3 Along these lines, ED NZ CS 3 acknowledges that compliance with the fairness principle may require CREs to make additional disclosures (on top of the Climate Standards) to fulfil the “fair presentation” standard. Since lengthy texts that include unimportant information are harder to decipher, the proposed framework instructs CREs to “ensure that relevant information is not obscured by the inclusion of immaterial details” (ED NZ CS 3, paragraph 7; consultation document, p. 11).
- 3.4 Similarly, the framework requires CREs to avoid “obscuring material information with immaterial information” or “aggregating material items that are dissimilar” (ED NZ CS 3, paragraph 8).
- 3.5 While CREs are required to eliminate disclosures that “are immaterial or redundant” (ED NZ CS 3, p. 8, Table 2), there are no concrete rules or objective criteria to determine whether the disclosure is, at the end of the day, “understandable”, “readable”, “clear”, or “concise”.
- 3.6 Therefore, that the proposed requirements pertaining to understandability and readability are too vague.
- 3.7 This ambiguity undercuts the ability of some actors – especially less sophisticated primary and other users – to read the disclosures and contribute to the public discourse about them.

Recommendation 3: *Adopt concrete understandability measures and readability tests suitable to the general public or “the reasonable person”.*³

The framework should determine concrete readability scores/metrics. For that purpose, it should employ established linguistic formulas (such as Flecsh-Kincaid readability tests) or advanced tools (such as the open-source CommonLit Ease of Readability (CLEAR) corpus) that can measure text readability and complexity.

Specific presentation principles – such as the introduction of headings and subheadings, paragraph numbering, table of contents, a one-page summary, and the elimination of ALL CAPS – can further promote understandability. See also recommendations 4-5 below.

³ We realise that the XRB has declined to adopt a “reasonable person” standard in another context (materiality); see ED NZ CS 3, BC28. We urge the XRB to reconsider this decision too.

4. Comparability and Consistency

- 4.1 Unified and consistent standards help people understand disclosures and make them more effective while reducing reading costs.
- 4.2 Concerning comparability, ED NZ CS 3 recognises that disclosed information is more useful if it can be compared with previous reports or information provided by other entities (p. 7, Table 1).
- 4.3 However, ED NZ CS 3 mostly⁴ suggests that “Climate-related disclosures are more comparable when they provide points of reference” while referring to “targets, a baseline, or an industry benchmark” (p. 7, Table 1).
- 4.4 We argue that the lack of a unified template for disclosures challenges comparability, especially amongst different CREs within an industry or sector.
- 4.5 A similar analysis pertains to consistency. Here, ED NZ CS 3 notes that “Information is consistent if the same approach or method is used from reporting period to reporting period” (p. 8, Table 1). ED NZ CS 3 further suggests employing “formats, narratives, and metrics that are consistent from reporting period to reporting period” (p. 8, Table 2).
- 4.6 Nonetheless, and despite the additional clarification regarding consistency in paragraphs 41-42 (and BC39-41), the proposed framework does not mandate or facilitate disclosure consistency. Alas, there are no proposed templates for all CREs to follow.
- 4.7 If anything, the framework legitimises some *inconsistency*. It notes that changes in metrics, narratives and formats are expected while requiring that “any such changes should be explained” (p. 8, Table 2).
- 4.8 Similar concerns regarding comparability and consistency apply to the requirements to report against three specific climate scenarios.
- 4.9 The XRB Board recognised that reporting about risks should involve scenarios that can be especially damaging to the entity, even if they are not the most likely outcome. The XRB Board thus asks entities to report on a “3 degrees Celsius or greater scenario to avoid entities not exploring challenging physical risk scenarios” (ED NZ CS 1 BC29(e)).
- 4.10 However, this is insufficiently prescriptive. In fact, each reporting entity is allowed to develop its own scenarios (subject to very broad constraints about the average annual temperature increase, as defined in ED NZ CS 1, p. 8, paragraph 12; see also ED NZ CS 3, paragraph 50).
 - 4.10.1 Remarkably, other supervisory authorities, such as the Reserve Bank of New Zealand (in its Climate Stress Testing for banks), provide much more specificity for the scenarios used. Applied in our context, an example

⁴ We use the term ‘mostly’ to acknowledge the guidance that paragraphs 39-40 provide. While this additional guidance is valuable, it does not substantially impact our evaluation.

might be a worst scenario that includes an X% increase in frequency or intensity of extreme flooding or a Y% change in the price of Z caused by the energy transition associated with that scenario.

- 4.11 Reporting against different scenarios challenges comparability. This, to use the language of ED NZ CS 3, may lead to scenarios that “are a ‘black box’ for primary users” (p. 26, BC45).
- 4.12 Tacitly acknowledging this comparability problem, CREs are encouraged to develop sector-specific scenarios against which each entity in that sector will report. Unfortunately, however, this sector-wide scenario standardisation is voluntary.
- 4.13 This voluntary regime presents three key challenges.
- First, assuming that all CREs will develop and adopt sector-wide scenarios is not trivial. Few sectors have a ready-made mechanism to collaborate (with limited exceptions, such as the insurance sector through the Insurance Council).
- Second, it is unclear that sectors are always adequately defined; as a result, some entities will inevitably end up reporting against their own unique scenario.
- Third, many CREs will choose the path of least resistance. They will develop their in-house scenarios, thus further damaging comparability.⁵
- 4.14 Overall, collaboration between competing entities within sectors does not usually result in advancing the public good and promoting comparability. More likely, CREs will collude to advance their shareholders’ interests. Indeed, it seems it is their fiduciary duty to do the latter.

Recommendation 4.1: *Adopt a standardised template or disclosure structure that all CREs must follow.*

Recommendation 4.2: *Detail specific mandatory climate scenarios against which CREs must report.*

5. Machine Readability

- 5.1 Humans have limited cognitive capacities, mental bandwidth, and attention span.
- 5.2 Mandated disclosures typically include an overwhelming volume of data individuals can hardly read and understand. Multiple disclosures in different domains exacerbate human’s inability to read disclosures and process them.
- 5.3 However, if the disclosed voluminous or complex data is machine-readable, humans can defer to machines and rely on technology to process the information.
- 5.4 A machine-readable document is a document that computers can automatically extract and process.

⁵ Indeed, previous feedback had suggested the XRB Board should create a single set of sector-level mandated temperature scenarios; see ED NZ CS 1, p. 22, CS28(b).

- 5.5 A document must be provided in an adequate digital format to be machine-readable. Machine-readable documents should include unique data identifiers and have a structured format and standardised taxonomy. These principles provide machines with the necessary context to easily read and process information.
- 5.6 Big data and recent developments in AI and sophisticated reading tools (for instance, GPT-3) offer significant social and economic benefits. Nonetheless, the proposed framework does not mandate that disclosures are machine-readable.
- 5.7 The fact that CREs are not obliged to make disclosures machine-readable weakens the disclosure effectiveness. It increases the costs of reading and comprehending disclosures and reduces the likelihood that people read them.

Recommendation 5: *Mandate CREs to ensure disclosures are machine-readable. We believe that promoting machine-readability will render much of the discussion around the location of disclosures obsolete.*

6. Regulatory Design: Periodic Reviews

- 6.1 A mandatory review/temporary legislation allows policymakers to re-consider its measures. It facilitates testing the proposed legislation when responding to dynamic circumstances and evolving needs and markets.
- 6.2 Introducing temporary legislation guarantees that policymakers and enforcement agencies re-examine the proposed framework after a trial period. It facilitates an opportunity to consider the growth in knowledge and the experience to date rather than succumbing to inertia.
- 6.3 A periodic review also allows policymakers to assess any beneficial or harmful unintended consequences arising from legislated requirements. In example in the context climate-related disclosure may include a hasty and disorganised de-risking that may respond to the need to disclose certain risks.
- 6.4 Likewise, given the complexity and novelty of the issue at stake, adopting an incremental approach will allow policymakers to experiment with the proposed framework.
- 6.5 A gradual and flexible approach is particularly important given the global and international interest – including in the EU and the United States – in implementing and advancing climate-related disclosure regimes. To be sure, there is considerable value in ensuring NZ benefits from aligning its approach with the international one.
- 6.6 In short, periodic review and gradual adoption allow policymakers and enforcement agencies to study the effects of the proposed disclosures. It provides an opportunity to learn how relevant stakeholders respond to and are impacted by the changing law and policy landscape.

Recommendation 6: *Introduce specific and clear checkpoints to re-visit the framework periodically; for example, after 2, 5 and 10 years of implementation.*

These revisions would prompt policymakers and enforcement agencies to examine whether the framework should be (1) expanded to other markets/smaller entities, (2) scaled down to decrease its scope (though this does not seem likely at this point), or (3) redefined to respond to emerging knowledge, accumulated experience, and other relevant developments.

NB: This recommendation aligns with the XRB's intention to begin a post-implementation review of the framework by December 2025 (ED NZ CS 1, p. 19, BC18; consultation document, p. 8).

Conclusion

NZ faces an opportunity to be a world leader in legislating effective disclosures that assist markets in reducing emissions and promoting climate resilience. Such disclosures are of paramount importance and should be optimally designed.

This submission calls for (1) expanding the definition of primary users, (2) introducing more prescriptive rules that may supplement vague or ambiguous principles, and (3) adopting a cautious regulatory approach. We believe that the above recommendations will increase compliance, promote certainty, and better advance the rationales and objectives that climate-related disclosures seek to achieve.

We hope you find this submission helpful. Please do not hesitate to contact us should you require any further information or clarifications.

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