

ISSB Sustainability Reporting Standards:

Comments on Exposure Draft IFRS S2 Climate-related Disclosures

1. Introduction

Shift welcomes the publication by the ISSB of a draft Climate standard for public consultation. Our organizational expertise is not in the science of climate change but in the human dimensions of sustainability, including as they relate to climate change and climate change strategies.

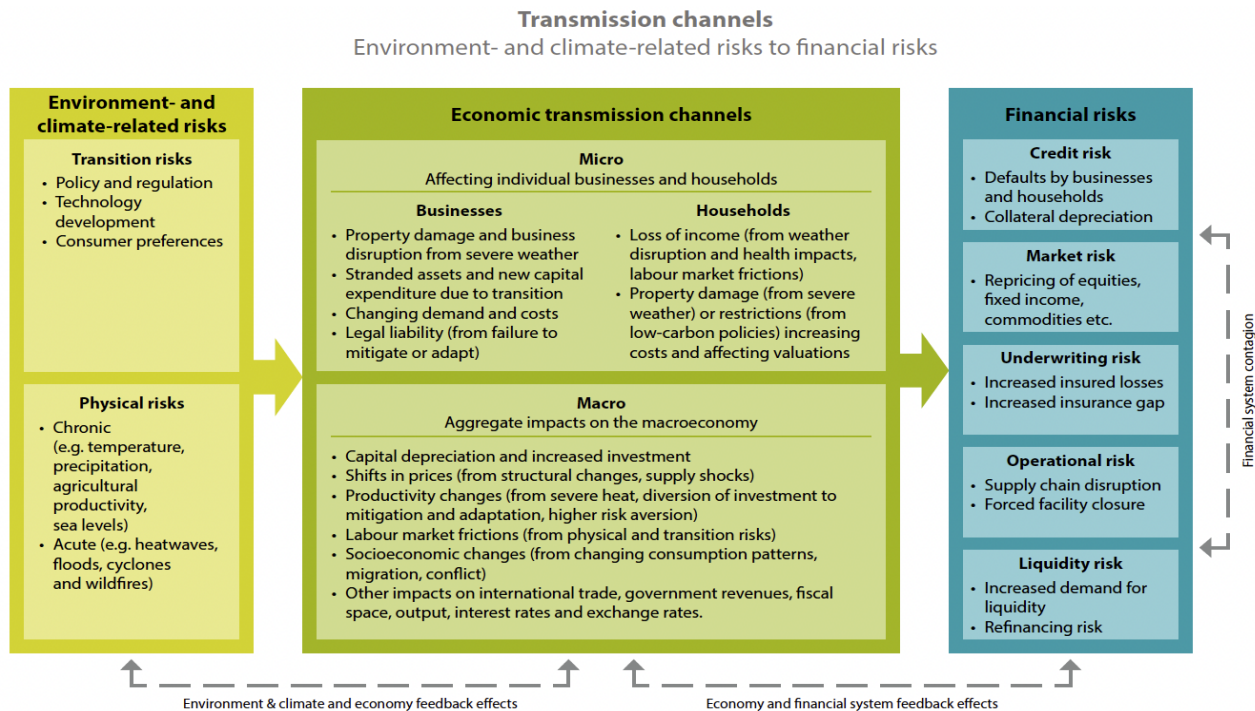
Climate change can have knock-on effects across regions and sectors, through interconnected socioeconomic and financial systems. The Bank for International Settlements (BIS) describes climate change as “*a new type of systemic risk that involves interacting, nonlinear, fundamentally unpredictable, environmental, social, economic and geopolitical dynamics*”. It goes on to state: “*With the complex chain reactions between degraded ecological conditions and unpredictable social, economic and political responses, with the risk of triggering tipping points, climate change represents a colossal and potentially irreversible risk of staggering complexity.*”¹

It is a widely recognized that the poorest communities and populations of the world are the least resilient to the physical impacts of climate change due to a combination of high vulnerability and low ability to adapt to the impacts of climate change. Transition risks also tend to disproportionately impact lower income communities and workers. The response by companies to the risks and opportunities related to both physical climate change and transition risks can exacerbate inequality and vulnerability and result in increased financial risks.

The potential transmission channels from **environmental and climate risks to financial risks** have been clearly illustrated by institutions like the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) in their 2020 report on environmental risk analysis², and in the diagram below. The NGFS focuses on financial institutions, but the reasoning and concepts can be equally applied to corporates.

¹ <https://www.bis.org/publ/othp31.pdf>

² <https://www.ngfs.net/en/overview-environmental-risk-analysis-financial-institutions>



In addition, the CDSB Framework for Reporting Environmental and Social Information, now part of the ISSB body of guidance documents, which rightly observes in Principle 3 that, ‘Environmental and social information are connected with each other where the organisation’s environmental performance has an impact on the organisation’s social performance, or vice versa’ and includes a number of climate-related examples.³

It is in light of these important interconnections and transmission pathways that we submit these comments to the ISSB to urge that the draft standard be revised to reflect these realities. Without this more holistic picture that integrates the human dimensions and implications of climate change, climate mitigation and climate adaptation, we will not only fail to achieve a just transition to carbon neutral economies, but will see continuing barriers to the success of undertakings’ climate change strategies, with consequences for business and the providers of capital, among others.

The following sections of this note provide a summary of the key issues raised with regard to the human dimensions of climate change and related reporting expectations, and brief recommendations for amendments in response to relevant points in the ISSB questionnaire. They cover the following issues: transmission channels from social impacts to financial risks (related to question 5); undertakings’ value chain and business model (related to question 4); the issue of trade-offs (related to question 2) and the question of time horizons (related to question 3(a)).

³ <https://www.cdsb.net/what-we-do/reporting-frameworks/environmental-information-natural-capital>

2. Transmission channels from social impacts to financial risks (response to Question 5)

There is increasing awareness of the potential social impacts from climate change that can increase financial risks.

2.1. What are social impacts?

- 2.1.1. There is international consensus regarding corporate responsibilities for adverse human rights impacts, as set out the **UN Guiding Principles on Business and Human Rights** and the **OECD Guidelines for Multinational Enterprises**. This international standard sets out the due diligence steps that organizations should follow to identify and assess adverse human rights impacts with which they may be involved, of which the most severe impacts tend to converge with risks to business, and provides a foundation for identifying material social information.
- 2.1.2 Social impacts are limits on or changes to the ability of people to realize their human rights, as defined by international standards, where these limits or changes are connected to an organization's operations, products, and/or services.
- 2.1.3 Social impacts can be relevant for the following four key groups of people:⁴
- The organization's **workforce**;
 - The workforce of entities in the organization's **upstream and downstream value chain** who have a role in the development or distribution of the organization's products or services;
 - **Community members** that can be affected by the organization's own operational sites or infrastructure or that of entities in the organization's value chain; and
 - **Consumers**, end users or others impacted by use of the organization's products or services.
- 2.1.4. In general, social impacts that may result in **negative financial outcomes**, may happen through changes in:
- The organization's access to a skilled and productive workforce (for example, reduced access caused by high employee turnover caused by dissatisfaction with wages and benefits, or illness caused by excessive overtime or poor working conditions);
 - The organization's social license to operate (for example, due to protest by affected communities, consumer boycotts, civil society or trade union campaigns or media critique);
 - Continuity or quality of supply and/or production (for example, due to workplace safety conditions; worker action including strikes; allegations of human rights impacts leading to export/ import delays, or delays in licensing or impacts on output due to conflict with affected communities);
 - Brand and reputational standing.

⁴ See also 'Terminology' section of *CDSB Framework for Reporting Environmental and Social Information*, page 8. Available at: <https://www.cdsb.net/what-we-do/reporting-frameworks/environmental-information-natural-capital>

2.2. Transmission channel: Transition risk & social impact

The need for a Just Transition

- 2.2.1 It is well recognized that a transition to a low carbon economy will impact workers and communities as companies exit fossil fuel related businesses and as the world economy transitions away from fossil fuel dependent growth. The concept of “Just Transition” recognizes that the transition should happen in a way that fairly shares the benefits of the transition while supporting those who will be negatively impacted.
- 2.2.2 Transition risk can result in social impact resulting in financial risk in the following ways:
- a. **Transition out** – i.e. away from emissions intensive activities. As companies transition to cleaner forms of energy and production, large amounts of jobs could be lost or replaced with lower quality jobs, which could result in social unrest and labor protests that could lead to financial risks. Transitioning out of traditional industries could lead to stranded assets that may result in stranded communities and the loss of cultural heritage, which could result in reputational and financial damage to companies if not managed well.
 - b. **Transition in** – i.e. into a green economy through the use of new technologies and renewable energy.
 - The increased demand for renewable energy, will translate into a significant growth in the demand for raw material such as cobalt and copper that have many well documented human rights risks in their supply chains. Even if an entity is not the direct cause of harm, it may still be contributing to the harm or be linked to it in way that results in reputational harm and increased financial risk.
 - Extraction of raw materials needed by a green economy could also add pressure on water supplies. For example, mining copper is a water-intensive process and even more water is needed as ore grades decline. Around half of existing global copper supply comes from three regions of water scarcity: Chile, Peru and the African copper belt. Water use by mines could result in water shortages for local communities, which could result in conflicts or protests that may result in reputational harm and increased and financial risk;
 - It is well documented that forced labor is endemic in parts of the solar supply chain. In an effort to address these human rights impacts, the U.S. government recently placed a ban on all products made in Xinjiang from being imported into the U.S. Actions like import bans in response to social impacts, could reach to disruptions in supply chains and higher costs for businesses.
 - Terrestrial wind and solar farms need a lot of land and when installation is not preceded by engagement and understanding impacts, it could lead to conflicts with local communities and indigenous people that could increase reputational and financial risk.
 - c. **Transition to net zero**: entities that rely on nature based off-sets could be causing, contributing or linked to social harms that may impact enterprise value. Some projects to reduce emissions from deforestation have been alleged to impact rights of indigenous peoples and new land is needed for new forestry projects that may also impact existing land rights, which may cause protests and disputes that could impact the reputation and enterprise value of an entity.

2.3 Transmission channel: Physical risk & social impact

The need for Just Adaptation

- 2.3.1 Even if aggressive climate mitigation action is taken worldwide, some effects of climate change are locked in and will continue to affect the climate in the coming decades. Adaptation is aimed at adjusting to life in a changing climate and adapting to actual or expected future climate. The goal of adaptation is to reduce an entity's vulnerability to the harmful effects of climate change (like sea-level encroachment, more intense extreme weather events or food insecurity). Depending on an entity's business model, geographical location and dependence on nature-based commodities, its exposure to physical risk may be even bigger than its potential exposure to transition risks. Its corresponding social impact and corresponding financial risk, may also be higher.
- 2.3.2 An entity's adaptation plans may not only impact its capital and investment needs, but may also have social impacts that could over time negatively affect enterprise value (in the same way as illustrated above for transition-related risks). Some examples:
- Building or strengthening infrastructure to protect its own assets from physical risks that increases the potential impact of physical risks on surrounding communities. For example, building flood defenses that increase the risk of flooding in surrounding communities, that could result in injury or death, increasing litigation risk and resulting in financial losses;
 - An entity that relied on rainfed crops in the past, may invest in irrigation infrastructure to adapt to drought conditions caused by climate change. Irrigation by the entity, may deplete water tables and resulting in water scarcity for surrounding communities leading to social unrest that negatively affects enterprise value;
 - If an entity's adaptation responses are not sufficient, it may also harm workers and have negative social impact. As temperatures increase it may no longer be safe for workers to work outside at certain times of the day or to work inside buildings without cooling systems. If workers are not provided with adequate protection, it could impact their health and even result in deaths which would carry litigation risks and reputational risks that could impact enterprise value.
 - If entities do not take adequate adaptation actions in factories or buildings, it could put workers at increased risk in the event of acute weather events such as storms or floods, which could increase litigation risk, reputational risk and damage enterprise value.
 - An entity's failure to take adaptation action could also harm surrounding communities. For example, if an entity fails to reinforce oil storage tanks against melting permafrost, it could lead to oil spills that cause environmental damage that deprives surrounding communities from their ability to make a living off the land in the area, which could increase litigation risk, reputation risk and damage enterprise value.

Response to Question 5 (e) and recommendation from Shift:

In light of the above, Shift recommends:

1. To add a requirement for companies to report on their adaptation plans to respond to the physical impacts of climate change. Depending on the entity's business model, geographical location and dependence on nature-based commodities, its exposure to physical risk may be even bigger than its potential exposure to transition risks.
2. To add a requirement that entities disclose how they addressed potential negative social aspects in transition plans and adaptation plans.

3 Social impacts through the Value Chain and through the Business model

Entities can **have** social impacts through their Value Chain and through their Business Model.⁵ For example:

3.1 Physical Risk:

- 3.1.1 The Business Model of a fast fashion manufacturer, may be based on producing large quantities of clothing at a low price that does not take account of the vast amounts of water used and polluted in the dyeing and manufacturing process. If physical climate increases the prevalence of droughts and the amount of available water reduces in the region, availability of water for surrounding communities and other businesses could be impacted. The scarcity of water in communities, may lead to protests, resulting in reputational damage and potentially financial losses. Local authorities may also start charging companies for water use, which could have a more direct impact on profitability.
- 3.1.2 The manufacturer could also be exposed through its Value Chain, for example if it relies on a commodity like cotton that may not be able to be cultivated in areas where it used to be due to physical climate change. If cotton production also relied on unsustainably low-cost labor, the manufacturer may also be exposed to reputational risk if it decides to exit the market that is no longer able to produce due to climate change if it had been exploiting low labour costs for a long time before its exit.

3.2 Transition risk:

- 3.2.1 Business model: A car manufacturer that produces cars with combustion engines could have a social impact if it starts to manufacture electrical cars in a process that is fully automated. It could result in large scale lay-offs that would have a direct financial impact or it could result in reputational damage that leads to lower enterprise value.

⁵ On the relevance of the business model for social issues, see also Requirement 2 of the *CDSB Framework for Reporting Environment and Social Information*, page 22.

3.2.2 Value Chain: as shown below, electrification can have social impacts through the value chain, which could result in reputational damage and lower enterprise value.



Response to Question 4 and recommendation from Shift:

As demonstrated above, there could be different risks in the Business Model and the Value chain, and therefore Shift recommends to treat these concepts separately in the draft standards.

4 Trade-offs (response to Question 2)

In their response to climate change, entities will inevitably be faced with trade-offs between sustainability targets and this could have social impacts that may result in higher financial risk. For example, setting a high target for recycled content in plastic products to respond to transition risk, could increase the demand for informal waste workers to collect materials since many countries do not have a plastics recycling infrastructure. Workers in the informal waste sector are often exploited and this could be a source of reputational risk for companies relying on recycled content.

Response to Question 2 and paragraph 5 (e) recommendation from Shift:

Entities are expected to disclose information about how trade-offs are assessed. It is inevitable that businesses will be faced with trade-offs in their response to climate change which could eventually result in financial risk and this will be a useful area of disclosure. However, the text appears to deal only with trade-offs between risks and opportunities. As shown above, there could be other trade-offs between sustainability targets and these should be assessed as well.

5 Time horizons (response to Question 3(a))

Time horizons for risk identification: risks that may not be significant over the typical business planning or reporting cycle, may have significant longer-term impacts and time horizons differ by industry and type of risk. Social risks may also arise over different time horizons compared to environmental risk and they may all result in financial risks. For example, a company reliant on a specific commodity may be able to respond to increasing drought conditions by irrigating crops. The irrigation may not have a financial impact during the typical 3-year business cycle, but the irrigation may eventually lead to depletion of the water table in the irrigated area, resulting in community protests and social unrest, reputational risk and eventually financial risk.

Response to question 3(a) and recommendation from Shift

In light of the different time horizons, we recommend that entities should not only describe how time horizons are defined, but also why such horizons are appropriate to assess longer-term viability of the company or its business model.