On the Radar

Climate Risk – Is it on Your Radar?

“Firms ignoring climate risk do so at their own peril.” This is the message from central bankers around the world. What does it mean for directors and their fiduciary duty to the companies that they oversee?

A consensus is emerging that climate change (and the actions required to address it) will have significant impacts on economies, financial systems and the companies that operate within them. Yet, climate change is a complex issue that requires directors to contemplate intersecting scientific, macroeconomic and policy-related uncertainty over long timeframes. These timeframes often exceed traditional strategic planning cycles.

Climate risk manifests itself in multiple forms and there is an increasing consensus on the need for action and credible disclosure. Fortunately, best practice expectations are evolving that can help guide directors as they identify, understand, monitor and oversee potential climate risks and opportunities.

What boards need to know?

Climate risks will manifest differently for different businesses.

The Task Force on Climate-related Financial Disclosures (TCFD) was an industry-led task force established by the Financial Stability Board to help identify the information needed by investors, lenders, and insurance underwriters to appropriately assess and price climate-related risks and opportunities. The TCFD recommendations provide guidance to businesses from all sectors about how to assess and disclose their climate-related financial risks – along with scenario-informed strategies for dealing with the impacts of climate change – and how to voluntarily integrate this information into their financial filings and existing disclosures.

For directors who wish to better understand the range of climate-related risks and how those may apply to their own companies, Section B of the final TCFD report[1] outlines these risks in more detail, along with the potential opportunities and financial impacts that they create.

These include:
Physical risks resulting from weather-related events and longer-term shifts in climate patterns that can lead to, among other disruptions: physical damage to assets; disruptions in the supply chain; extreme temperatures; changes in water availability, sourcing, and quality; shifts in growing patterns; and droughts, flooding and forest fires.

Transition risks which include: the policy, legal, technology, reputational and market risks and opportunities stemming from the inevitable transition to a lower-carbon economy, including greater demands for disclosure, carbon pricing, technology substitution, litigation, changing customer demands, and/or societal acceptance of your transition strategy.

Public opinion is galvanizing.

Central banks, investors, lenders and insurance underwriters have all stepped forward to acknowledge the global scientific consensus on the risks and severity of climate change. The consensus is that climate change is happening, it is global, the consequences are severe and intensifying, and anthropogenic (human-caused) factors are the driving force.

More recently, public concern has catalyzed into “climate strikes,” with millions of students, activists and workers demanding action to limit further climate change. The number and volume of international movements and demonstrations is growing, as is the pressure on governments and corporations – and thus, boards – to act.

Climate impacts are manifesting quickly.

It is now widely acknowledged that the accumulation of greenhouse gases (GHGs) in the atmosphere is driving unprecedented climate changes, the impacts of which are significant and have the potential to directly or indirectly threaten all communities and businesses. Human activities are transforming the atmosphere at an accelerated rate, increasing the atmospheric concentration of carbon dioxide, methane and other GHG emissions to levels unseen in the past 800,000 years.[2]

1 TCFD, *Recommendations of the Task Force on Climate-related Financial Disclosures* (www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf, 2017)

2 United Nations, *800,000 Years of Carbon Dioxide*. (www.climatecentral.org/gallery/graphics/800000-years-of-carbon-dioxide, 2019)

Climate change generates physical and transition risks and impacts that will continue to emerge and intensify for the rest of the century. Many of these effects are already being felt globally, such as elevated sea levels, pervasive biodiversity loss, ocean acidification, extreme weather events and a growing number of climate-related social crises.

The demand for disclosure is growing.

Given the need to better understand and quantify climate-related risks, there is a growing demand for useful climate-related information that is transparent, consistent and comparable. Investors, lenders, insurers and customers expect boards to ensure that climate-related risks and opportunities are being systematically embedded into the company's strategic planning.

An increasing number of companies are now voluntarily disclosing their climate-related risks in alignment with the TCFD recommendations.[3]

Regulation is on the horizon.

While climate risk disclosure is currently voluntary, it is expected that regulations making it mandatory are coming. As national governments begin to implement policies that support a transition to a low-carbon economy, companies will be required to adapt to this new regulatory atmosphere.

Canada, the United Kingdom and the Republic of Ireland have all declared a climate emergency, as have more than 500 cities and municipalities around the world.[4] Meanwhile, litigation over climate rights and climate liabilities is on the rise, with energy companies facing lawsuits from cities, counties, states, fishers and farmers. Governments are also facing lawsuits from their citizens – including children – with cases occurring in the United States, Canada, Netherlands, United Kingdom, Ireland, Pakistan and Colombia.[5,6]

Regulations and litigation have the potential to reshape the way governments, communities and industries think about climate change consequences and how we should respond to them. Between carbon taxes, cap-and-trade programs, restrictive legislation and even lawsuits to protect communities, companies may find it difficult to carry on with "business as usual."

There is growing pressure for companies to articulate how they are responding.

In addition to disclosing their exposure to climate-related social, environmental and economic risks, a growing number of companies are committing to operate within the limits of key social, environmental and economic systems. Scientists commonly discuss the notion of preventative

3 TCFD, *Recommendations of the Task Force on Climate-related Financial Disclosures* (www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf, 2017)

4 The Climate Mobilization, *Climate Emergency Campaign* (www.theclimatemobilization.org/climate-emergency-campaign, 2020)

5 Vox Media, *Pay attention to the growing wave of climate change lawsuits* (www.vox.com/energy-and-environment/2019/2/22/17140166/climate-change-lawsuit-exxon-juliana-liability-kids, 2019)

6 Inside Climate News, *A Surge of Climate Lawsuits Targets Human Rights, Damage from Fossil Fuels* (https://insideclimatenews.org/news/04012019/climate-change-lawsuits-2018-year-review-exxon-fossil-fuel-companies-human-rights-children-government, 2019)

limits that identify a factor of safety, a zone of uncertainty, or a "buffer" distance from a threshold, which is the point at which the resiliency of a system becomes compromised.

Senior executives and directors have articulated three key benefits of adopting a contextual approach to climate change that acknowledges and adheres to such limits:

- Anticipating complex and potentially disruptive risks through systematic consideration helps manage disruptive risk through proactive responses.
- Anticipating shifting societal expectations helps maintain and enhance societal acceptance.
- Prioritizing where it makes the most sense to allocate scarce resources helps develop a clear and credible narrative about where and why the company will direct its efforts.

In regard to climate change, many initiatives are pressing companies to set science-based targets. One example of this is the commitment to limit the global rise in temperature to 1.5°C above pre-industrial levels.

One fifth of Fortune Global 500 companies have committed to set science-based emissions reduction targets,[7] and a growing number of them are issuing position statements on carbon and other topics that include commitments to respect social and ecological limits.

Companies are increasingly expected to take a public position on carbon and climate change.

As demands for corporate social responsibility intensify, investors are seeking a clear position that specifically addresses a company's understanding of the context in which it operates and clarifies its role and commitments to address the climate crisis. By developing position statements, boards and executive teams deepen their understanding of these issues in the context of their business, clarify the link to the company's overall strategy, illuminate their position for key stakeholders, and provide the direction and confidence for management and employees to act.

A good position statement on climate change will do three things:

1. Explain the company's understanding of climate change, including what its leadership sees as relevant limits.
2. Clearly link climate change to the business's strategy.
3. Make a credible commitment to take appropriate actions.

For companies considering writing or updating their climate position, a recent guide issued by the Embedding Project provides a step-by-step checklist along with examples from a range of industries and global settings for crafting a board position statement on the issue

7 Science-Based Targets, *Surge in global business embracing climate science to navigate low-carbon transition* https://sciencebasedtargets.org/2018/09/13/surge-in-global-business-embracing-climate-science-to-navigate-low-carbon-transition, 2018)

of climate change.[8] Produced with financial support from CPA Canada, this guide builds on an analysis of more than 1,200 climate statements and more than 300 interviews with CEOs, directors and board chairs.

Directors should be asking these questions about climate risk.

In taking a position about climate change, the questions boards should ask themselves include the following:

- Does our company understand its climate-related risk? Have we engaged in a thorough risk assessment?
- Do we disclose our climate-related risk in alignment with the recommendations of the TCFD? If not, why not?
- Are we prepared to credibly respond to inquiries? Have we developed a credible public position on climate?
- Have we set credible goals related to our role in climate mitigation and climate adaptation?
- Have we developed a credible plan to deliver on these commitments?
- Are we making the necessary resource investments to meet our commitments?

8 *Next Generation Governance: Emerging Trends in Climate Change Position Statements* (www.embeddingproject.org/resources/next-generation-governance-emerging-trends-in-climate-change-position-statements, 2019)