

Climate Change Risk : The Role of the Board



Dr. S. K. Gupta
Managing Director
ICAI Registered Valuers
Organization

Climate Change risk is an issue facing all businesses – no matter the location, sector or product. It has evolved from a purely 'ethical' 'environmental' issue to have mainstream recognition as a material financial risk across physical, economic transition and litigation dimensions. For both corporate and public sector entities, regulatory and investor expectations on climate risk assessment and disclosure are accelerating, posing both risks and opportunities that need understanding, assessment and appropriate action. Increasingly, a strategic, rather than compliance-focused, approach to climate risk governance translates to commercial advantage in dealings with customers and investors.

Climate Change is visibly disrupting business. As with any form of disruption, Climate Change is creating and will continue to create risks and opportunities for business in a diverse number of ways. This disruptive relationship between Climate Change and business is already receiving increased attention. This has been prompted by the Paris Agreement, the emergence of climate-related legislation, the recommendations of the Financial

Stability Board's Task Force on Climate-Related Financial Disclosures (TCFD) and, most recently, the heightened awareness of physical impacts and risks detailed in the Special Report of the Inter-governmental Panel on Climate Change (IPCC) on Global Warming.

The links between Climate Change and business are becoming increasingly evident and inextricable. Increasingly, board directors are expected to ensure that climate-related risks and opportunities are appropriately addressed. Climate Change is simply another issue that drives financial risk and opportunity, which boards inherently have the duty to address with the same rigour as any other board topic. On the other hand, climate change is a new and

complex issue for many boards that entails grappling with scientific, macro-economic and policy uncertainties across broad time scales and beyond board terms. In this regard, general governance guidance is not necessarily sufficiently detailed or nuanced for effective board governance of climate issues.

What is Climate Change?

Climate Change refers to long-term shifts in the earth's weather patterns that can be caused by natural phenomena or human activity. Today, the term is commonly used to mean rising average global temperatures caused by the concentration of greenhouse gas emissions (GHG) in the atmosphere.



Risks created by Climate Change:

Global corporations are facing an era of unprecedented business disruption and transformation as a direct result of climate change. Given the increased investor and societal pressure, corporate leaders recognize it would be perilous to ignore this. Climate risks can impact revenues, costs and risk profiles of companies, generally in a negative direction, causing earnings and cash flow to vary from expectations with growing regularity.

Climate Change risk includes physical risk, transition risk and liability risk. Briefly:

Physical risk includes financial risk arising to the lowering of asset values, increased frequency of insurance claims, or the disruption of the supply chain arising from changing climate conditions or extreme weather events that cause direct damage to property or assets.

Transition risk relates to the policy changes, technological innovation and social adaptation which causes disruption from the adjustment to a

low-emission economy. Here, financial risk lies in the impact on pricing and demand, stranded assets, and defaults on loans.

Liability risk arises from stakeholder litigation and regulatory enforcement. This is the direct consequence of not responding to the impacts of climate change, leaving businesses open to litigation.

Why is Climate Governance a board responsibility?

In recent years, enterprise risk has become more complex and interdependent. A critical emerging enterprise risk for many companies is Climate Change. Boards should understand and fully address their fiduciary responsibilities as it relates to the oversight of climate-related risks. Accordingly, each director must have a common understanding of their individual, committee, and overall board responsibility related to climate risk oversight.

Climate Governance is the structure of rules and processes a company puts in place to manage its responses to the financial risks and opportunities of Climate

Change. Climate change is a potential strategic risk to companies, and it is therefore the duty of the board to identify and manage it in the same way as any other strategic risk. Whether or not climate is specified as a fiduciary duty under the corporate governance code, directors have the duty to promote the success of the company and to act with due care, skill and diligence. Failing to identify, assess, deal with or disclose material climate risks is a potential failure of corporate governance.

Board members or their companies may expose themselves to legal action if they fail to identify, respond to or disclose material climate risks. The risk of exposure is particularly high for directors of companies that operate in sectors that are especially vulnerable to climate risks, namely energy; transportation; agriculture, food and forest products; materials and buildings and financial services.

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An effective Climate Governance structure is critical to ensure that a company properly assesses climate-related risks and opportunities, takes appropriate strategic decisions on how to manage those risks and opportunities, and sets and reports on relevant goals and targets. Without governance in place, a company will be ill-equipped to deal with the threats or to respond appropriately to shareholders. As boards navigate their approach to climate-risk governance, questions to consider may include:



What are the top climate-related risks for the company?

How does the board determine the materiality of risks?

How are the company's key financial metrics affected by climate risks?

How are these risks reflected in long-term strategic and financial planning?

How does the board set goals and measure performance on the company's management of climate-related risks?

Which board committee has primary responsibility for overseeing the company's climate strategy and risk management?

Does the board hear from outside experts, including those whose views may diverge from management's?

How does the board oversee risks and opportunities related to Climate Change; in particular, how does the board ensure all members have an awareness and understanding of climate risk?

How does the board integrate Climate Change risks and opportunities into overall enterprise risk management?

Do external stakeholder expectations, such as investor mandates or shifting customer preferences, warrant focused attention from the board?

How is climate risk integrated into the organization's enterprise risk management program?

Board-level oversight ensures a company's long-term resilience concerning potential shifts in the business landscape that may result from Climate Change. A climate-competent board will

As the stewards for long-term performance and resilience, the board should determine the most effective way to integrate climate considerations into its structure and committees.

Integrate subject matter expertise or perspectives related to climate risks and opportunity.

Ensure that climate risks are integrated into the company's investment planning and strategic decision-making processes.

Incentivize performance by including climate-related targets and metrics in executive compensation schemes.

Ensure that material climate-related risks are consistently and transparently disclosed to all stakeholders.

Maintain regular dialogues with peers, policymakers, investors and other stakeholders to stay informed about the latest climate-relevant risks and regulatory requirements.

Appropriate board governance may require additional training for directors or recruitment of members with the requisite knowledge and skillsets to provide robust oversight of management as the company identifies and responds to climate-related risks and opportunities.

At its 2019 annual meeting in Davos, the World Economic Forum (WEF) published guidance for corporate boards on how to establish Climate Governance at their companies. The climate governance guidance from WEF covers 8 principles:

Principle 1: Climate accountability on boards. The board should take responsibility for ensuring the company's long-term resilience to climate risks.

Principle 2: Command of the subject. The board should be properly informed about Climate-related risks and opportunities and able to make relevant decisions.

Principle 3: Board structure. The board should implement the right board and Committee structures to ensure that climate risks and opportunities are understood, managed and reported.

Principle 4: Material risk and opportunity assessment. The board should ensure that



management fully identifies climate-related risks in the short, medium and long term, assess their materiality, and takes appropriate action according to the materiality of the risks.

Principle 5: Strategic integration. The board should ensure that management factors material climate-related risks and opportunities into the company's strategy, risk Management Process and Investment Decisions.

Principle 6: Incentivisation. The board should align executives' incentives with the Long-term success of the business. This may include climate-related targets in executive incentive schemes.

Principle 7: Reporting and disclosure. The board should ensure that the company discloses its material climate-related risks, opportunities and strategic decisions to all stakeholders - especially investors and regulators. These disclosures should be Included in financial reporting.

Principle 8: Exchange. The board should stay informed on current best practice in Climate Governance by maintaining dialogue with peers, policy-makers, investors and others.

Closing thought

Board-level focus on climate risk preparedness will help clarify the risks and opportunities associated with climate change. While pivoting from business as usual to a climate-risk preparedness mindset may be seen as cumbersome, it is necessary. Delaying appropriate action now may put the company at a competitive disadvantage later and could even erode shareholder and stakeholder value. Prudent boards will communicate climate change as a risk or opportunity multiplier; companies that capitalize on climate-risk opportunities may drive increased customer and employee engagement and benefit from future resilience and competitive advantage.

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