ARTICLE

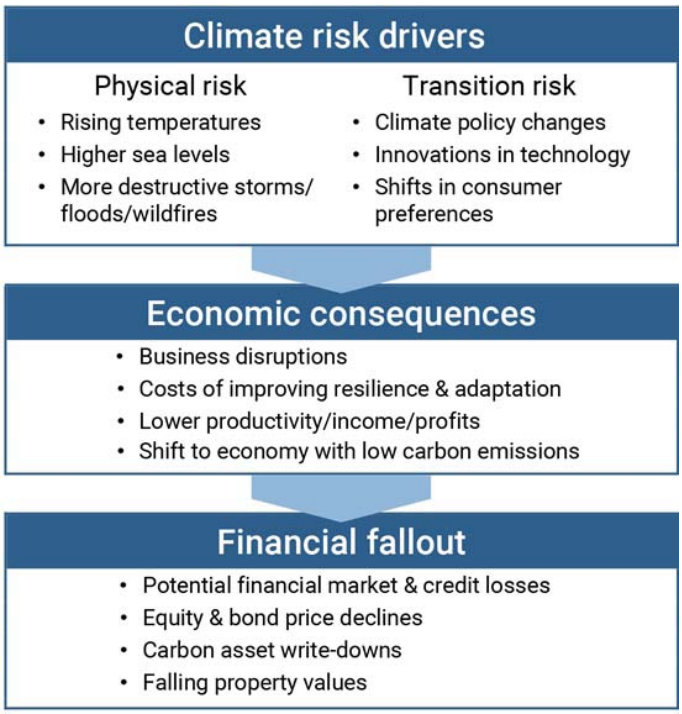
Putting Climate Action at the Heart of Sustainable Value Creation - Board's Role

**Yukti Arora & Jyoti Sngh*

Introduction

The Global Risk Report 2020 (of the World Economic foundation) states that for the first time in the history of the Global Risks Perception Survey, environmental concerns dominate the top long-term risks by likelihood among members of the World Economic Forum's multi-stakeholder community; three of the top five risks by impact are also environmental. “Failure of climate change mitigation and adaption” is the number one risk by impact and number two by likelihood over the next 10 years, according to the survey. The Report emphasizes that worldwide economic stress and damage from natural disasters in 2018 totalled US$165 billion, and 50% of that total was uninsured.

Globally, investors, creditors, insurers and customers are increasingly demanding for more specific information about an organisations' exposure to, and management of, climate related risks. Climate change has rapidly evolved from an 'environmental, non-financial' issue to a mainstream financial risk impacting almost all sectors of the economy. Over 40 central banks and supervisors are already examining how climate risks can be integrated into their economic and financial activities. Governments are also moving towards mandatory disclosure of climate risks by listed companies. The investor community is also responding to climate risk, with a recent notable development being the launch of the UN-convened Net Zero Asset Owners Alliance at the 2019 United Nations Climate Action Summit.



FRSBF Economic Letter – Climate Change is a Source of Financial Risk

“Directors' Liability and Climate Risk: Comparative Paper – Australia, Canada, South Africa, and the United Kingdom” issued by Commonwealth Climate and Law Initiative (CCLI) identifies physical impacts and transitional risks. Physical impacts (both acute catastrophic and gradual onset) such as sea level rise, species loss and extinction, increased ocean acidity, and an increase in the frequency and intensity of

extreme weather events, create risks to health, livelihoods, food security, water supply, and human security with consequences for productivity, supply chain integrity, and the costs and availability of finance and insurance. Transition risks arise from the inexorable shift towards a net-zero emissions economy, and associated shifts in the regulatory, technological and stakeholder landscape within which business operates. While these risks compound over the medium and long-term, they are increasingly relevant within shorter-term, mainstream investment horizons.

Climate Risk Assessment

It is thus extremely important that organization adopt robust risk management approach to address climate risk. Organization's principles and values should drive process of climate risk management. The first step for same includes performing climate risk assessment which may be classified into following broad themes:

Policy

Risk assessment should be done to understand climate change policy, reporting as per its principle of transparency, relevance and comparability. For example, it could cover assessment on emission to air, water, land, resource use, supply chain and product. Index like implementing carbon-pricing mechanisms to reduce GHG emissions, shifting energy use toward lower emission sources, adopting energy-efficiency solutions, encouraging greater water efficiency measures, and promoting more sustainable land-use practices. This can be quantitatively and qualitatively measured and benchmarked for assessment of risk.

Ethics, Brand and Reputation

Organizations in current world are expected to be responsible. Climate risk is one of the highest emerging risk and response to them can directly be associated to organizational principles and ethics. Exploitation of environment has a direct bearing on brand and reputation. Companies need to evaluate its vulnerability to environment related commitments, carbon emission, energy usage, climate-related effects such as regional shifts in the availability of energy and water, reliability of infrastructures and supply chains, etc. Boards should systematically assess these risks and then decide which to reduce through redesigning operations, which to transfer to others through insurance or hedging contracts, and which to bear. Pre-emptive steps through risk management may enable companies to build reputation and brand and demonstrate their commitment as being truly responsible and sustainable.

Strategy and Technology

Company should perform risk assessment to understand and strategize investment as well as timing for development and deployment of use of emerging technologies such as, renewable energy, battery storage, energy efficiency, and carbon capture and storage. This should be assessed from perspective of its effect on their competitiveness, demand for their product and services and their production and distribution costs. Resource aggregation and supply models, water treatment innovation, hybrid car, solar and wind energy usage, renewable battery, e-books, e- learning, remote diagnostic and treatment, etc., are some of positive disruptive models and innovative product and services which have emerged and can further emerge from opportunities arising from climate change.

Market condition including Demand and Supply aspects

Climate change may result in variety of impacts including epidemic, diseases, injuries, soil erosion, excess or shortage of crop, irrigation issue, power outage, need for more energy for heating/cooling, wildfire, increased water demand, insect infestation, land degradation, livestock death, shortage of fresh water, human migration and property loss. All this not only changes demand and supply, but will substantially impact economy across sectors, impacting hardest banking and insurance sector since they touch all industry sectors. All companies across Industry sector need to assess risks since they may directly (agriculture, real estate, chemical, transportation, hospital and hospitality, etc) or indirectly be impacted (chemical, manufacturing, logistic, etc). Risk should assess impact on human settlement, human health, on agriculture, forestry, ecosystem and water to clearly understand market.

Though the ways in which markets could be affected by climate change are diverse and complex due to climate related risk and opportunities, it is essential that organizations adopt scenario analysis or predictive analytic to access shifts in supply and demand for certain commodities, products, and services and be prepared to respond to climate-related risks and opportunities. The upside could be development of new market and new industry altogether like, for instance environment purifier, organic farming, heating and cooling, renewable energy, waste disposal technologies and biotech, etc.

Finance and Corporate Asset

Climate change impact on market conditions, particularly supply and demand, can be a key determinant of future prices and in turn, affect the rate of return on investments. If risks are not properly assessed and manage then organizations could struggle on operational efficiency since climate impact may bring change in the productivity, open cost, maintenance cost and performance of assets and equipment, this may adversely impact revenue in short term and investment yield over longer

term. Further, banking and insurance costs may need to be assessed since it may change adversely in affected market. Asset replacement and complying with environmental regulations may require assessment due to climate risk. Thus, organizations need to assess climate impact for complete financial modelling, cash flow projection, contingency projection and overall return on investment. Proactive assessment may enable organizations to diversify, identify alternative areas of demand, manage operational cost, improve or sustain value of physical assets and generate sustainable return on investment.

Staff health, Safety and Productivity

Physical climate severity risk needs to be assessed which may result in increased risk of injury, diseases water and air borne, epidemic, skin allergy and infection, respiratory and other chronic disease. Thus, requiring organizations to assess risk and manage risk relating to staff health and productivity. Organizations may also be required to assess climate impact of the region as this may impact organization's ability to operate in sustainable manner in that region, since business strategy may require complete risk review if there is risk of longer-term shifts in climate patterns.

Regulatory and Litigation Risk

Regulatory issues need to be assessed from risk perspective, in particular, keeping in view regulatory issues at stake and industry standards being developed. Companies needs to assess and define effect, and identify the compliance burden and how advantages can be delivered. At a minimum, all companies should assess risk and at minimum assess and respond to their carbon footprint—where their emissions are coming from and in what amounts including that of their suppliers.

Another important risk to be assessed is litigation or legal risk which requires efficient governance and regulatory risk management framework encompassing ever evolving climate change related regulations. Regulation and litigation broadly may relate to human right, international treaties, environment law, sustainability reporting requirements, health and safety law and contractual commitments. In recent years there has been an increase in climate related litigation claims being brought before the courts by property owners, municipalities, states, insurers, shareholders, and public interest organizations. Companies also need to also be aware of public interest organizations representing for human right preservation and constitutional remedies around same.

Organizations for effective assessment may use scenario analysis, predictive analytic and projection technique. This will enable them to explore the impacts of different climate futures on their industry and organization and understand the scale of change and the timing of change. Once analysis is done, there is need to look based on risk evaluation and risk treatment wherein risk decision could be taken to explore new opportunities and also manage downside impact of climate risk. Risk based decision could include avoiding the risk by deciding not to continue and adopting resource efficiency and cost savings; or taking or increasing the risk in order to pursue an opportunity by the adoption of low-emission energy sources, the development of new products and services, access to new markets, and building resilience along supply chain.

Organizations may also address risk by removing the risk source by selecting for instance alternative product, increasing green initiatives or changing the likelihood or the consequences by reducing carbon emission. They could also share the risk by taking insurance and efficient contracting. Once understanding has been gained, they could assess their climate resilience and take decision on measuring and retaining risk through informed risk-based decision process.

Risk Management Oversight

To effectively respond to climate risk there is need for board oversight and governance. Often leadership at executive level are governed by delivering result as per projected performance metric, and in absence of adequate board oversight and incentive they may not focus on long term sustainability investment and return. It is thus role of board to provide holistic sustainable guidance and enable organization to take risk-based decision. They may assist organization in ensuring adequate climate risk disclosure thus enabling investors to understand the organization's strategies, financial plan and compare risks and opportunities. Some of frameworks/ standards which can be adopted are as below

Frameworks/ Standards For Climate Reporting/ Disclosure

In 2015 ESG goals and disclosures gained momentum as the United Nations adopted the 2030 Agenda for Sustainable Development, which includes **17 global Sustainable Development Goals (SDGs)**. Further, the G-20 asked the Financial Stability Board (FSB), an international body that monitors and makes recommendations aimed at promoting financial stability, to develop a framework for climate-related risk disclosure that could be used by financial institutions, companies, and investors. That year, the FSB launched the **Task Force on Climate-Related Financial Disclosures (TCFD)**, which published its final recommendations, including guidance for the financial sector, in 2017. The TCFD provides a management structure for businesses to approach climate-related risks and is perhaps the most widely adopted framework

calling for disclosure of climate-related risks. The Task Force's 2017 report provides context, background and the general framework for climate-related financial disclosures.

While work on many frameworks and standards for climate disclosure began years before, interest in and adoption of disclosure frameworks and standards blossomed after 2015, spurred on by increasingly dire reports from the Intergovernmental Panel on Climate Change.

Global Reporting Initiative (GRI) was founded in 1997, and has been setting standards around environmental accountability since 2000, which expanded to include social and governance standards as well. Its sustainability reporting standards, in place since 2016, may now be the most widely used sustainability standards. The **European Commission's Non-Financial Reporting Directive (NFRD)** was a 2014 European Union legal mandate that, via national implementation, required large publicly listed companies as well as large banks and insurance companies (whether listed or not) to begin disclosing in 2018 information on sustainability issues. On 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the NFRD.

In 2018, the **Sustainability Accounting Standards Board (SASB)**, completed its sector-by-sector sustainability standards, recommending that companies disclose the financial effects of sustainability in a manner similar to, and subject to the same rigor and internal controls as, traditional financial disclosures. In November 2020, SASB announced that it is merging with the International Integrated Reporting Council to form the Value Reporting Foundation.

The U.K.-based **Climate Disclosure Standards Board (CDSB)**, an international consortium of business and environmental non-profits, published its updated framework for reporting environmental and climate change information in 2019. The international non-profit **CDP (formerly the Carbon Disclosure Project)** sends detailed questionnaires covering climate, forests, and water security to thousands of companies, cities, states, and regions annually, compiling the information for use by investors, purchasers, and city stakeholders. The **Partnership for Carbon Accounting Financials (PCAF)**, which began in the pivotal year of 2015 as a project of 14 financial institutions in the Netherlands and is now expanding internationally, launched a consultation in 2020 of its accounting methodologies for financial institutions.

In a notable development, the I**nternational Financial Reporting Standards (IFRS) Foundation**—which oversees the **International Accounting Standards Board (IASB)**, an independent group of experts who develop the International Financial Reporting Standards—announced in September 2020 that it is actively considering how to incorporate technical ESG metrics into its standards, likely through the creation of a parallel Sustainability Standards Board. Finally, in September 2020, the CDP, CDSB, GRI, IIRC, and SASB committed to working together toward a global comprehensive corporate reporting system and to engaging with the IFRS Foundation, and the International Organization of Securities Commissions, on how to connect sustainability disclosure standards to accounting standards.

The 2019 survey Task Force on Climate-related Financial Disclosures highlights lack of standardized metrics and targets for climate related disclosures. The lack of consistency in the indicators and the difference in the methodologies used to calculate and present the figures reduces the usefulness of the information provided by companies.

Board's Role In Climate Risk

Regulatory and investor trends are driving increased corporate attention to climate change and many boards are struggling to address the related risks and opportunities in a holistic way. World Economic Forum in its paper “How to Set Up Effective Climate Governance on Corporate Boards – Guiding Principles and Questions” states that as a foreseeable financial issue within mainstream investment and planning horizons, climate change should enliven directors' governance duties in the same way as any other issue presenting financial risks. The paper lays down following guiding principles for Boards to consider -

Principle 1 – **Climate accountability on boards** - The board should be accountable for the company's long term resilience with respect to potential shifts in the business landscape that may result from climate change.

Principle 2 – **Command of the (climate) subject** - The board should ensure that its composition is sufficiently diverse in knowledge, skills, experience and background to effectively debate and take decisions informed by an awareness and understanding of climate-related threats and opportunities.

Principle 3 – **Board structure** - 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.

Principle 4 – **Material risk and opportunity assessment** - The board should ensure that management assesses the short-, medium- and long term materiality of climate-related risks and opportunities for the company on an ongoing basis. The board should further ensure that the organization's actions and responses to climate are proportionate to the materiality of climate to the company.

Principle 5 – **Strategic and organizational integration** - The board should ensure that climate systemically informs strategic investment planning and decision-making processes and is embedded into the management of risk and opportunities across the organization.

Principle 6 – **Incentivization** - The board should ensure that executive incentives are aligned to promote the long-term prosperity of the company. The board may want to consider including climate-related targets and indicators in their executive incentive schemes, where appropriate.

Principle 7 – **Reporting and disclosure** - The board should ensure that material climate-related risks, opportunities and strategic decisions are consistently and transparently disclosed to all stakeholders – particularly to investors and, where required, regulators. Such disclosures should be made in financial filings, such as annual reports and accounts, and be subject to the same disclosure governance as financial reporting.

Principle 8 – **Exchange** - The Board should maintain regular exchanges and dialogues with peers, policy-makers, investors and other stakeholders to encourage the sharing of methodologies and to stay informed about the latest climate-relevant risks, regulatory requirements, etc.

Conclusion

Climate change is expected to affect multiple sectors, geographies, and assets globally, sometimes simultaneously and within a relatively short timeframe. Risk management and adequate measurement and disclosure by companies of information on material, climate-related financial risks is an essential building block to ensure that climate risks are measured and managed effectively. Board oversight on same is essential for sustainable growth of company. Board must assess and respond timely to ensure responsible growth and overall sustainable recovery where damage is already done.

**Ms. Yukti Arora* *is a chartered accountant with around 21 years of post-qualification experience with Big 4 in field of risk management and assurance, including sustainability. She currently is CEO of Aumyaa consulting services, providing consulting and training services to corporate. She has contributed number of publications in various journal and has delivered several lectures for ICAI, ISACA and IIA.*

**Ms. Jyoti Sngh* *is a chartered accountant with around 19 years of experience in assurance, corporate governance, risk management and sustainability. She has contributed in a number of publications and is currency pursuing research in Sustainability Reporting.*

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