GOVERNANCE

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Caveat praesidium – Chair beware

'It is easy to see how for many boards having short tenure Chairs may create unintended consequences. Understanding these potential consequences could start influencing the appointment process and potentially lead a nomination committee to disqualify otherwise highly qualified candidates due to restraints on tenure length.'

John Dawson and Michael Henson

Climate governance considerations for boards

'Climate change poses challenges for boards on many levels. It is a risk that is unique for businesses in its scope and scale, yet due to the complex and diverse nature of the issue, it remains poorly understood by many.'

Margaret-Ann Splawn

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Climate governance: considerations for boards

Margaret-Ann Splawn looks at both the challenges and the opportunities that climate change presents to businesses and how boards should address them.

Environmental regulatory and policy changes are happening fast. Disclosure reporting is on the rise and this article addresses what company directors, boards and businesses should be thinking about in relation to climate change.

Corporate governance in the UK is globally respected and provides a framework that allows investors to trust where to allocate capital. The Financial Reporting Council (FRC) published the new UK Corporate Governance Code together with revised Guidance on Board Effectiveness last summer, with the new Code commencing on or after 1 January 2019. The new Code, which is shorter and sharper than the previous Code, considers economic and social issues to guide the long-term sustainable success of UK business, and promotes transparency and integrity in business for society as a whole.

Board leadership and company purpose

Under the new Code, the board's role is to 'promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society'[1]. The new Code specifically includes the word *sustainable*. Defining what sustainable means within your own company context is important if the board is to lead successfully, climate change presents the single biggest threat to sustainable development everywhere and it's widespread. Sustainability is fast becoming a metric on how a business is judged by its customers, workforce, society and its investors. With this in mind, companies should ensure that directors have some knowledge, expertise or training on sustainability or climate risks facing their operations.

Climate: It all starts with governance

Governance of climate change in the current global international context is based upon the United Nations Framework Convention on Climate Change's (UNFCCC) Paris Agreement[2], agreed in 2015 which came into force in 2016. At the time of writing, 185 countries out of 197 Parties to the Convention have ratified it. The Paris Agreement deals with greenhouse gas emissions, mitigation, adaptation and finance, with the aim to limit global average temperature rise to well below 2ºC.

The iconic Paris Agreement paved the way for increased regulatory trends across nations to mitigate greenhouse gas emissions, often seen via the setting of reduction targets and increasing incentives for the use of renewables. Reporting obligations on greenhouse gas emissions, including climate related risk exposures, are also part of this movement, and the UK's Financial Conduct Authority is actively engaged in this new regulatory focus. They published a discussion paper on climate change and green finance in October 2018[3], with findings from a call for comments in January this year yet to be released. But it is not just the UK that is interested in green finance. Climate change is now a leading issue for investors around the world, and in the past two years alone, global social responsible investments have grown by 34%, reaching $30.7 trillion[4].

Risks here, risks there, risks everywhere!

Climate change poses challenges for boards on many levels. It is a risk that is unique for businesses in its scope and scale, yet due to the complex and diverse nature of the issue, it remains poorly understood by many. Climate risk exposure can impact a company's balance sheet and financial performance. Companies are facing greater *regulatory risks* and changes, inconsistencies and uncertainties in regulation create strategic challenges.

Physical risks

Boards must increasingly consider the *physical risks* to their businesses and physical assets caused by rising global temperatures and unpredictable weather. Weather-related losses – both insured and uninsured – have been much higher in recent decades[5]. Meanwhile, gaps on how to measure these risks persist due to diverse information formats, limited scenario analyses, limited coverage of climate data and limited transparency of methodologies[6].

Transition risks

Transition risks can occur when moving towards a less polluting economy. The speed of transition can affect certain sectors, particularly those that utilise a lot of energy, as well as financial stability. Independent financial think tank Carbon Tracker estimates that fossil fuel companies risk wasting $1.6 trillion of expenditure by 2025 if they base their business on emissions polices already announced by governments, instead of basing it on international climate goals[7].

Liability risks

Liability risk is another consideration for boards, emerging from individuals and businesses seeking compensation for losses they may have suffered from the physical and/or transition risks of climate change. For example, earlier this year, Pacific Gas & Electric (PG & E) – a regulated utility that serves roughly 5.2 million households in northern California – was heralded as the first 'climate change bankruptcy' when they filed for bankruptcy in the face of liabilities for $30 billion or more following wildfires that swept across its service areas.

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Companies and individuals will likely face *higher insurance costs* due to climate-related impacts. Munich Re, the world's largest reinsurance firm, warns that insurance premiums will be affected by increasing wildfires, flooding, storms and hail, and will adjust their risk prices accordingly[8].

Financial risks

Climate change can impact a company's balance sheet, and thus may also generate a *financial risk*. Mark Carney, FSB Chairman and Governor of the Bank of England, famously spoke at Lloyd's of London on 29 September 2015 about 'breaking the tragedy of the horizon – climate change and financial stability'[9]. Carney explained that 'once climate change becomes a defining issue for financial stability, it may already be too late'.

Scientists show the projected impacts of this argument in publicly available assessment reports, and the Intergovernmental Panel on Climate Change (IPCC) released a special report in October 2018 outlining the devastating economic and social impacts of allowing average temperature to rise 2ºC above pre-industrial levels, rather than the 1.5ºC target.[10]

Increasing disclosure

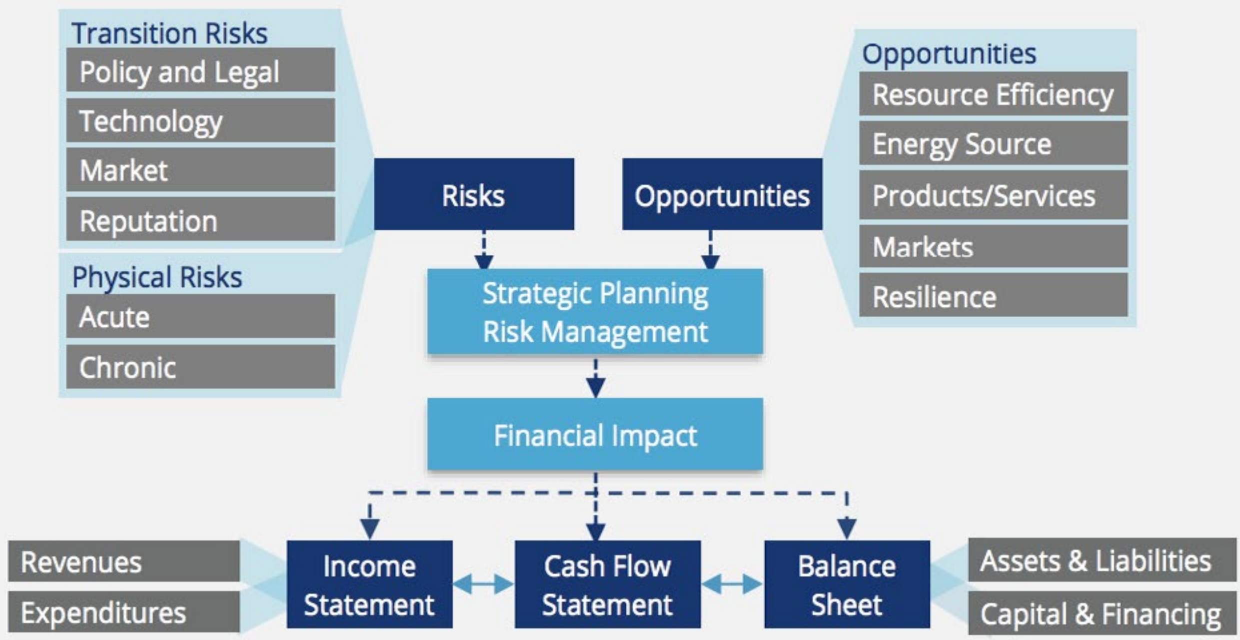
What the data shows is that climate change is not only an environmental problem, but a business one as well. Climate change poses financial risks for companies, and thus for investors too. With this in mind, Carney, together with Michael Bloomberg as Chair, created a Task Force on Climate Related Financial Disclosure (TCFD), which in 2017 issued recommendations designed to help companies disclose decision-useful information. The recommendations are devised to create consistent, comparable, reliable, clear and efficient disclosures of how climate-related risks are assessed, priced and managed. Being armed with this intelligence will, it is hoped, allow investors and the wider financial markets to better understand climate-related financial risks and opportunities.

Figure 1 below is taken from the TCFD Report and illustrates how climate-related risks and opportunities can have financial impacts on a company's balance sheet.

However not all disclosure reporting is voluntary and transparency reporting is on the rise. For example, in 2015 France introduced their Energy Transition for Green Growth Act (Article 173 – VI), requiring all institutional investors to report on the integration of climate-related risks in their investment policies.

Figure 1

Climate-Related Risks, Opportunities, and Financial Impact



Source: https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-2017-TCFD-Report-11052018.pdf, page 8

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Where there are risks, there are opportunities
'Climate change is simply another issue that drives financial risk and opportunity, and boards inherently have the duty to address with the same rigour as any other board topic.'[11]

Investors have woken up to the need for climate competent boards and establishing effective climate governance is becoming an integrated part of a company's responsible stewardship. Accordingly, many companies are changing the way they approach strategic planning and operations. For example, conducting a physical risk assessment of assets increases understanding of the implications and resilience of climate-related risks, such as flooding or droughts.

After facing a recent string of high-cost natural disasters, AT&T is looking for ways to increase their resilience to climate change. AT&T paid for research to model flooding, hurricanes and wind storms in several US states in order to 'understand the potential impacts of climate change in up to 30 years in the future'.[12] Going forward, AT&T will use the information to guide their $20 billion annual capital investment spending, and plan to make their infrastructure and built environment more resilient to climate change impacts.

Some companies are structuring investments for longer-term returns to ensure a sustainable future for their business: environmentally, socially and financially. There is also an increasing trend to use or implement an internal carbon price (or carbon shadow price) to assess the possible cost and impact on product price. The idea is to make environmental costs part of broader economic analyses, influencing decisions regarding project investment and helping to identify the price of pollution in a transparent way.

New products, services and policies
Creating new and different products, services and policies that capture climate-related opportunities are also being developed by forward thinking companies. For example, TPT Retirement Solutions has both a Climate Change Policy and Responsible Investment Policy, ensuring that they consider climate risk in the investment process and actively engage with the wider investment community on climate change.

Brand leader Kering S.A. – who owns luxury brands such as Gucci and Yves Saint Laurent – has gone a step further and developed an innovative tool for measuring and quantifying the environmental impacts of its activities called Environmental Profit & Loss (EP&L). The EP&L measures carbon emissions, water consumption, air and water pollution, land use, and waste production along the whole supply chain. The impacts of all of the Group's activities are visible, measurable and comparable, and can then be converted into monetary values to quantify the use of natural resources.

HSBC, one of the world's largest banking and financial services organisations, has been a long-standing supporter of its customers operating in the energy sector. However, in the latest update of its energy policy, the bank announced an almost global ban on financing new coal-fired power plants. Interestingly, HSBC's Group Head of Strategy, Daniel Klier, is also their Global Head of Sustainable Finance – just another example of a smart approach to dealing with the complex issue of climate change.

Sustainable Development Goals
One global trend that businesses are developing is the integration of the *Sustainable Development Goals* into their company reporting. At the heart of the 2030 Agenda for Sustainable Development are the 17 Sustainable Development Goals (SDGs), a call to action to all countries covering the three dimensions of sustainable development: economic, social and environmental. Interest in the SDGs is rising in the business and investor communities and one in four of the world's largest companies are referencing these goals in reporting and major investors with $4 trillion in assets are making commitments to the SDGs.[13]

Moving forward
Sustainable business is the way forward and it transcends sectors and jurisdictions. The TCFD spent 18 months developing their recommendations, which are based on four thematic areas related to how businesses operate. The first area is governance around climate-related risks and opportunities, followed by strategy, risk management, and metrics & targets. As of April 2018, more than 275 companies – with a combined market capitalisation of more than $6.6 trillion – have expressed support for the recommendations.

Boards need to lead strategy and take ownership on climate governance. Here are five key recommendations for boards to integrate climate change into business strategy:

1. Determine what governance on climate change should look like for your organisation at a board level. Define how climate should be included in reports – both in board reports and company financial reports.
2. Evaluate your company's full exposure to climate change – conduct a gap analysis and adopt a shadow carbon price.
3. Develop a climate change strategy or policy that aligns with your corporate priorities.
4. Identify the risks and opportunities for your long-term sustainable business model. Taking effective action can turn risk into a competitive advantage.

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5. Build capacity of the board and executives – develop skills and knowledge in areas of sustainable business practice, climate change policy and climate related risk that filtrates throughout the entire company, inspiring cultural change. Business as usual is no longer an option and this change must come from the top.

Margaret-Ann Splawn is Executive Director of the non-profit Climate Markets & Investment Association (CMIA) www.cmia.net . She can be contacted at margaret.splawn@cmia.net. She is a Fellow of the Royal Geographical Society and graduate of the FT Non-Executive Director Diploma.

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