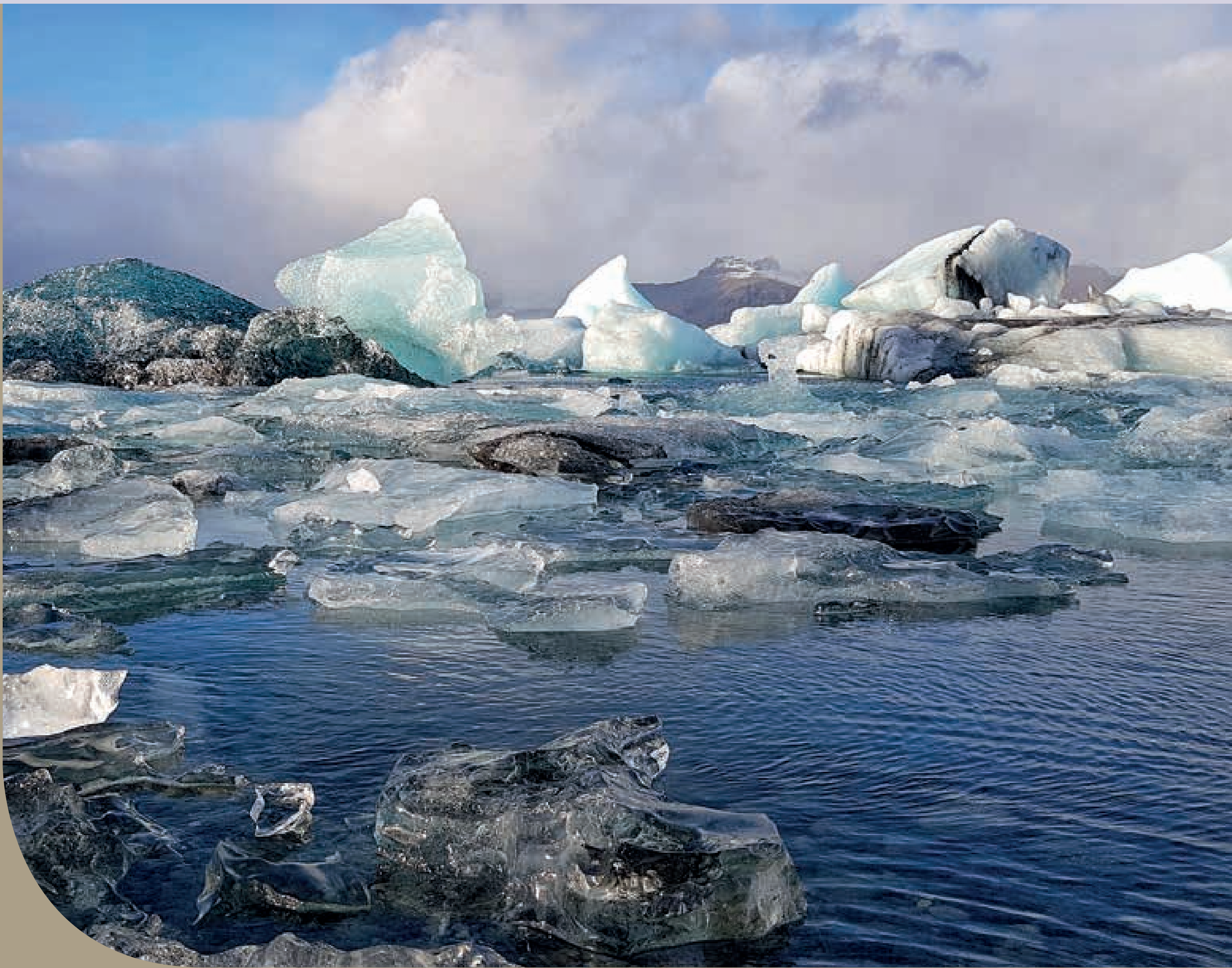
RAMPING UP CLIMATE ACTION BY ENHANCING COMPANIES' GOVERNANCE FRAMEWORK



The focus on environmental risks to the global economy has grown in prominence in recent years. Such risks dominated the World Economic Forum *Global Risks Report 2019*, for example, for the third year in a row, accounting for three of the top five risks by likelihood and four by impact. Interestingly, as evidenced by the supporting global survey, a widely shared perception is that increased occurrences of extreme weather events are linked to a "failure of climate-change mitigation and adaptation" policies, especially after Paris.[1]

The 2015 Paris agreement on climate change (the "Paris Agreement") includes a call for action by all with explicit reference to the critical role of non-state actors, including businesses, in its implementation. For a truly sustainable economy investors and companies should understand and measure their environmental impact. At the same time, climate change can affect a company's portfolio and operations, so urgent actions are needed to identify and mitigate company's climate risk exposure.

In its latest report issued in September 2018, the Inter-Governmental Panel on Climate Change (IPCC), the United Nations body for assessing the science related to climate change, drew extremely alarming conclusions: even if the ambitious objective set by the Paris Agreement to contain global warming to 1.5°C was to be achieved, substantial impacts will be felt in every region of the world.[2]

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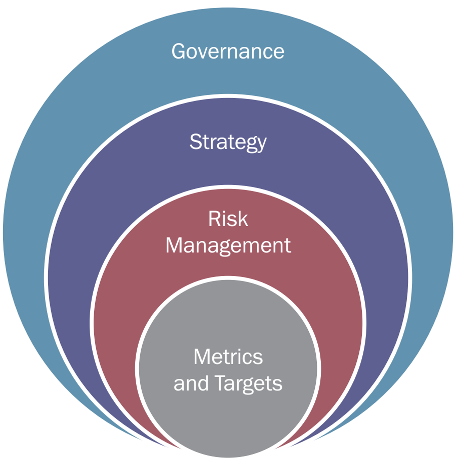
The 2017 report of the Task Force on Climate-Related Financial Disclosures (TCFD),[3] a market-driven initiative, examines climate change in a financial stability context and constitutes a solid basis to help companies tackle the adverse impacts of climate change. The TCFD's recommendations are structured around four major thematic areas – governance, strategy, risk management, and metrics and targets – adoptable across sectors and jurisdictions (see Chart 1).

The TCFD recommendations ask for a better understanding of the nature of climate risk and climate-related financial disclosures. For decades organisations have been reporting on the risks they encounter, often as a statutory obligation to do so. Risks can be defined generally as outcomes that can negatively impact different risk targets, including the company's capital resources, revenues, net sales, expenditures and liquidity. Climate-related risk is a possible negative outcome that could affect all or any part of a company's financials (including expenditures, revenues, assets and liabilities, capital and financing) as a result of climate change.

Climate risks can be broadly classified into *transition* and *physical* risks. Transition risks include diverse policy, legal, technology, market and reputational risks that organisations might encounter due to the effect of new laws and policies designed to mitigate climate change, or market changes as economies transition to renewable and low-emission technology. A special sub-set of this category, is litigation risk which can be mitigated by effective governance, risk management and disclosure. Physical risks include acute risks, referring to those driven by events (such as the occurrence and increased severity of extreme weather events) and chronic risks (that is, longer-term shifts in climate patterns, such as sustained higher temperatures that may cause sea level rise, heatwaves, and so on).

Chart 1: Extract of the TCFD final report showing four layers of company's response to climate change



A wide range of organisations are exposed to climate risks, in particular organisations with long-lived fixed assets (for example, fossil fuels), with locations or operations in climate-sensitive regions (for example, coastal and flood zones); that rely on availability of water and that have value chains exposed to the above. So the identification, assessment and management of climate-related risks, in many cases, are an essential part of prudent business strategy and risk management, which suggests that reporting practices should be extended or adapted to apply to climate-related risk.

FINANCIAL IMPLICATIONS OF CLIMATE- RELATED RISKS AND OPPORTUNITIES

There is no doubt that climate change may have a significant financial impact. However, the financial impact of climate-related risks on individual businesses is not always clear and, for many businesses, identifying the issues, assessing potential impacts and ensuring that the material issues are properly managed can be challenging.

Climate change may fundamentally impact market or customer demand for a company's products or services, and possibly the timing of when demand occurs. This is the case with the clothing manufacturer Superdry, which suffered a £10 million profit cut in 2018.[4] The "unseasonably hot weather" observed during the summer and autumn in most of Europe and the east coast of the USA resulted in a severe drop in sweatshirts and jackets sales, which normally account for 45 per cent of the firm's annual sales.

In the context of transition risks, companies may face legal and regulatory risks due to the changing regulatory environment if their business plans and strategies are not aligned with the transition to a low-carbon economy. Investors are increasingly demanding that companies adopt adequate

> "Many of the economies where the EBRD invests are particularly vulnerable to climate risks."

strategies to reduce their greenhouse gas (GHG) emissions and to adapt to lower-carbon economic outlooks.[5] In the power sector alone, it is estimated that stranded assets in the 2°C scenario would total US$ 320 billion worldwide over the period to 2050, while only 5 per cent of physical risk losses are covered by insurance in developing countries.[6]

Along with the severe impacts on firms' financials, climate-related risks can impact the cost of sovereign borrowing in developing countries. A recent report prepared by the Imperial College Business School and SOAS University of London concludes that climate vulnerability has already raised the average cost of sovereign bond yields by 1.17 per cent. The report also highlights that the poorest countries are the most likely to suffer from climate change, and thereby pay the highest cost of capital.[7]

EBRD CLIMATE GOVERNANCE INITIATIVE

Companies from emerging economies are often seen as less attractive for investors due to a higher level of risk influenced by geopolitical instability, poor infrastructure, suboptimal technologies, an immature legal and court system, and other factors. In addition, developing countries and emerging economies may be more dependent on natural resources than advanced economies (for example, reliance on the agriculture sector) and often located in regions that may be more exposed to climate-related risks.

Many of the economies where the EBRD invests are particularly vulnerable to climate risks. Deficient regulatory and institutional frameworks and lack of ambitious climate policy agenda result in a scarcity of climate-related data and low market action on building climate resilience. As a private sector investor with a clear environmental mandate[8] the EBRD is well placed to support companies in its regions to enhance their governance responses to climate-related risks and opportunities. Building on the TCFD report, the Legal Transition Programme, together with the Energy Efficiency and Climate Change and the Economics, Policy and Governance units of the EBRD (the "team") launched in April 2018 an initiative to better understand the type of support and guidance companies in emerging economies may need ("Enhancing Organisation's Governance around Climate-related Risks and Opportunities" or the "project"). The EBRD retained a consortium of Ernst & Young, Norton Rose Fulbright LLP and Mott Macdonald to assist in the implementation of the project.

As part of the project, the team carried out an overview of: (i) climate-related financial disclosure standards and frameworks; (ii) main drivers for companies and national governments to ramp up climate action; and (iii) legal risks of non-engagement. In addition, the team conducted a stakeholder consultation with companies from a range of sectors, identified as leaders in climate governance and risk management. The outcome of the consultation helped understand better the drivers that encourage companies to tackle climate risks and introduce governance processes and mechanisms; it also highlighted the success factors and barriers they faced.

The project's objective is to put together recommendations for strengthened governance that lead to better incorporation of climate-related risks and opportunities into the company's business model and strategy.

Another outcome of the project is to highlight the key role of national authorities in helping companies in emerging markets to adopt and implement these recommendations, in order to advance a transition to a low-carbon and resilient economy. This article provides an overview of the research, key findings and success factors for climate action developed as part of this project.

Climate change litigation

As referred to above, inadequate climate action by businesses or national authorities (for example, central or regional government) carries litigation risk concerns. Such concerns have become particularly relevant over the last couple of years as research has revealed that the number of climate change litigation cases is significant and continues to rise rapidly, with over 1,100 cases being brought to date. Climate change litigation can be divided into two main categories: (i) private law claims based on tort, planning, company law and fraud, and (ii) public law actions against governments and public authorities, brought on the grounds of human rights, constitutional and administrative law violations.

A significant number of claims against companies are on the grounds of directors' duties to disclose climate-related risks and adopt well-functioning governance structures to address the transition to lower-carbon scenarios (for example, investor/shareholder claims). Further, climate litigation claims can be based on tort (for example, nuisance, trespass, negligence, which may be brought against pension funds, trustees, directors, surveyors and contractors); product liability (for example, against manufacturers and distributors whose products have serious impacts on the environment), misrepresentation and fraud (for example, against listed companies).

The potential cross-jurisdictional impact of tort liability claims related to climate change can be seen in the case Lliuya v RWE AG, Germany's largest electricity producer.[9] While an application for strike-out was successful initially, in November 2017 this decision was overturned as the appeals court found that a private company could potentially be held liable for the climate change related damages of its greenhouse gas emissions. The case is ongoing and a successful outcome for the claimant could set a precedent for future climate change litigation cases.

Another recent example is the lawsuit brought against ExxonMobil which is considered to be a "turning point" for climate litigation, particularly regarding directors' duties. New York's Attorney General has accused the US oil giant of engaging in a fraudulent scheme to deceive investors, including equity research analysts and underwriters of debt securities, about the company's management of risks posed by climate change regulation. The case was admitted on jurisdiction and is ongoing.[10]

When it comes to claims brought against national governments, these are mainly aimed at compelling states either to cease acting, or take positive action to adopt ambitious mitigation or adaptation policies.

One of the most high-profile examples where a government has been forced to take action is the Urgenda case. In September 2015, Urgenda, a Dutch environmental group, together with 886 Dutch citizens, brought proceedings in the Hague District Court to compel the Dutch government to adopt more ambitious climate mitigation targets. In a landmark decision, the court ordered the Dutch government to enact policies to reduce GHG emissions to minimum 25 per cent below 1990 levels by 2020. On 9 October 2018, the Dutch government's appeal of the ruling was dismissed.[11]

In summary, the key drivers for launching climate change litigation are:

- requiring governments or regulators to take action to meet national or international commitments. Such action may include adopting, upgrading and/or effectively applying climate change related policies and legislation.
- preventing future emissions and contributions to climate change.
- receiving compensation for the costs of adaptation to climate change.
- raising awareness and exerting pressure on corporate actors, regulators or investors.

CLIMATE-RELATED FINANCIAL DISCLOSURE REGIMES

Due to a long-standing lack of attention to climate-related risks at the board level, TCFD reports that information on companies' climate-related resilience strategies and financial implications remains limited and inconsistent. Reducing information asymmetries and improving companies' governance and disclosure arrangements are key to achieving the Paris Agreement's goals. In this context, national authorities are responsible for adequately addressing climate change impacts, which include setting the policy framework and providing data, tools and guidance to private sector actors to effectively measure, evaluate and manage their own risks and those of the market. As such, increasing transparency and mainstreaming reporting on how such risks are identified and dealt with would catalyse action and help monitor progress as it enables information flows between national authorities, companies and investors. Better transparency would contribute to more consistent and coherent identification and assessment of risks.

The team's research has mapped out a gradual move of national governments and regulators towards developing guidelines and regulatory frameworks for enhancing disclosure in relation to climate-related financial risks applicable to financial institutions, insurers, institutional investors, issuers of securities and other companies. While there are country- and sector-specific particularities, it is possible to identify a few notable developments below.

With article 173 of the Law on Energy Transition for Green Growth, France has become the first country to require investors to disclose information relating to their contribution to climate goals. The French legislator has adopted the "comply or explain" approach, which does not impose a specific method of compliance but obliges institutional investors to provide information on and justification of the methodology used. Among other things, this approach discretely pushes companies to tackle identification of and reporting on climate risks.

Financial regulators increasingly make the case of treating climate risk as a matter for regulatory intervention. The UK Financial Conduct Authority's Discussion Paper on Climate Change and Green Finance, clearly provides such arguments with the objective of protecting and enhancing the integrity of the UK financial system. The Prudential Regulation Authority (PRA) has launched a consultation with banks and insurers, which expired in January 2019, on how firms can apply effective governance, risk management, scenario analysis, and disclosures in order to address the financial risks from climate change. The intended outcome of the consultation is that regulated companies take a strategic approach to managing the financial risks from climate change, which may require development or update of PRA supervisory policies in line with its mandate to maintain monetary and financial stability.[12]

> "What can make one company change its strategy on tackling climate-related risks? In some cases it can be a disclosure requirement and in others it is stakeholder pressure. Coming under investor pressure the energy giant Shell recently announced that it will link executive remuneration to reduction of GHG emissions from 2020 onwards."

Some emerging economies have started strengthening extra-financial reporting. In 2017, the Moroccan Authority for Capital Markets (AMMC) and the Casablanca Stock Exchange, for example, released guidance to promote extra-financial culture and disclosure within the corporate sector. This guidance also supports companies using public loans to adapt to possible mandatory environmental, social and governance reporting.

The European Union (EU) is moving towards a disclosure regime. In January 2019, the European Commission Technical Expert Group (TEG) on Sustainable Finance published non-binding guidelines for climate-related disclosure, which includes sector-specific recommendations and additional reporting criteria for companies with significant climate risk exposure.[13] The TEG had been asked to make recommendations for revision of the Commissions' non-binding guidelines of the EU Non-Financial Reporting Directive (NFRD) governing disclosure of climate-related information in line with the TCFD. The TEG's report covers in detail the companies' governance and disclosures with a particular focus on financial sector firms. The arguments provided in the report related to the materiality of climate risks and the need to adopt urgent actions encourage the understanding that such risks, when material, should indeed be captured by financial reporting.

Voluntary climate disclosure initiatives

More companies have opted to provide information about their climate risk exposure beyond regulatory requirements. Research shows that among numerous voluntary disclosure standards, companies opt for the most detailed ones such as the Carbon Disclosure Project (CDP). CDP represents over 650 investors with US$ 87 trillion[14] of assets, which is more than the global GDP. It is a tremendous platform that has transformed corporate governance and carbon management by promoting transparency and accountability. It allows companies to benchmark their performance against peers which will undeniably have positive implications for the individual companies and the sector overall.

Increasingly, investors are taking a position to mitigate the threats of climate change. In recent months, investors overseeing US$ 32 trillion in assets signed up to the Investor Agenda – an initiative created to accelerate actions critical to achieving the goals of the Paris Agreement. Other initiatives include Climate Action 100+, UK's Green Finance Task Force (GFI), the Sustainable Stock Exchange Initiative and many more. An UN-led initiative calls for banks to consider borrowers' voluntary disclosure information in assessing their credit risk.[15]

SUCCESS FACTORS FOR BETTER CORPORATE GOVERNANCE AROUND CLIMATE-RELATED RISKS

Based on the outcome of the stakeholder consultation carried out by the EBRD, the team established that companies' strong governance mechanisms are essential to efficiently identify, assess, manage and report on climate risks and opportunities. It is paramount that companies include the topic of climate change during all board meetings or any meetings when group strategy and business plan are discussed, and therefore make sure that the top management is kept informed on climate change issues. Further, companies should ensure that the implementation of an efficient and appropriate climate policy, prepared by climate change experts, is reviewed and approved at board level. All governance bodies involved at various levels of the company should be well coordinated on the issues of climate change, allowing for example the sustainability committee to work regularly and efficiently with the risk committee, the health and safety executive committee, and others.

Drawing from this work, the EBRD project team developed a set of recommendations, intended to be practical and applicable to companies across sectors in emerging markets. While some companies are at the very beginning of their reflection on how to integrate climate-related risks into their general strategy, action plan and governance structure, others are already quite advanced. These recommendations are intended to support companies at any level of "climate maturity". During interviews the team has established that even the leading companies have to put in substantial efforts in order to improve the management of climate risks. In terms of disclosure a few of the multi-nationals have appealed for better coordination and consistent efforts applied by national regulators and supra-national organisations.

Companies at the very beginning of their reflection on how to manage climate risks, that do not yet have any structure for climate governance in place, need to put in place the initial governance practices presented in the box opposite.

Companies that already have a good basis and need guidance to enhance their management of climate-related risks should focus on more advanced steps.

ROLE OF NATIONAL AUTHORITIES

Despite varying disclosure quality, regulatory and voluntary disclosure frameworks have ensured that companies start identifying and mitigating their climate risk exposure, across both non-financial and financial sectors by strengthening their governance and risk management mechanisms.

In emerging markets, however, private climate action has been slow and research indicates that companies may be subject to a wide array of inconsistent disclosure regimes, with different reporting requirements and scrutiny levels. Insufficient harmonisation of standards and governance benchmarks can hinder the comparability of the information provided by companies and thus prevent effective monitoring by the market and governments.

For this reason, it is important that national authorities engage with stakeholders to elaborate on disclosure guidelines and tools, to enhance consistency and comparability. To help advance this discussion, the team has compiled a list of good practices for climate action, which may facilitate data availability, institutional transparency and good corporate governance around climate risks. In a number of emerging economies, governments should establish a comprehensive framework within which climate action can be advanced, with statutory targets, clear assignation of duties and responsibilities within the state agencies, and regular reporting. The growing attention to climate risk by financial authorities mainly in the developed markets over recent years is exerting a parallel set of pressures for companies to act, even where political commitment has not manifested in clear actions. This means that, in addition to environment ministries, the financial regulators will have an increasing role to play in

First steps towards effective governance around climate-related risks and opportunities

Clearly define the role, responsibility and accountability of all governance bodies involved; ensuring efficient communication and coordination between them by:

- establishing a separate committee tasked with identifying and managing climate-related issues, ideally chaired by the CEO
- announcing the CEO's (or other senior executives') commitments to set out and adhere to a clear policy for tackling climate-related risks and opportunities
- defining the frequency with which climate change risk and opportunities are discussed at Board level and plan regular meetings with CEO/top management to keep them informed on climate-related financial issues.

Further recommended actions for more "mature" organisations

- train key management and executive staff on the topic of climate risks (both transition and physical)
- work with local teams on scenario modelling to use as a key tool for organisation decisions
- collectively engage in sectoral initiatives to develop methodologies and tools
- initiate co-learning events (roundtables, online platforms), allowing for discussions and sharing best practice at the sector and regional level on physical climate risks.

Table 1: Good practices for national authorities to support climate action (with a particular focus on physical climate risk)

Success factor	Best practices for national institutions
Regulatory reporting frameworks have been a key driver for companies to disclose on climate risks	Set a clear national climate policy framework to provide the necessary long-term clarity
	Enact regulatory reporting frameworks, fostering risk and strategy-oriented disclosures
	Provide guidance to support companies in this reporting exercise and help them go beyond simple compliance
	Build clear indicators that would allow companies to assess their contribution against national adaptation targets
Better access to data is a key enabler for understanding physical climate risks	Facilitate access to regional or local-level data that is necessary to understand physical climate risks.
	Facilitate multi-stakeholder initiatives at local level involving all concerned parties likely to provide data and help understanding the impacts of physical climate risks.
Partnerships with expert scientific and analytical organisations can help companies overcome the lack of data and methodologies	Support the development of sectoral methodologies and tools that can act as a baseline for companies to start working with the same understanding of physical climate risks
	Support the development of collective initiatives and partnerships gathering companies and civil society, public institutions, and others. These initiatives contribute to creating momentum and traction on specific issues.
Further guidance on "good governance" can help address climate risks	Internal change management and updating processes to adequately address climate risks is a multi-year process. However this could facilitate the process of more consistent interpretation of climate risks by companies.

setting a stable landscape in which companies can respond with good governance of their own climate risks.

Governance of climate change risks is a complex problem and to develop an effective solution there needs to be a strategic leadership at a company and business level. It also requires cooperation between (i) governance structures at a company level; (ii) institutional structures at a government level (central and regional/local); and (iii) national authorities and companies on climate risks for a particular country, in particular in relation to physical climate risk.

CONCLUSION AND NEXT STEPS

Climate change generates a new set of challenges and opportunities for business. In the coming years, business success will be strongly associated with how well climate risks and opportunities are integrated into core business and strategic planning.

In the journey to adequately mitigate climate change impacts and build resilience, national governments and regulators have a central role to ensure consistency, clear guidance and information-sharing in relation to assessing, reporting and disclosing climate-related financial risks. Given the challenges posed by climate-related risks to companies and national authorities, the EBRD and other multilateral development banks can play a constructive role to support these actors in emerging markets by channelling climate finance while promoting an enabling environment for the transition to a low-carbon economy and supporting capacity-building and knowledge-sharing initiatives across sectors and jurisdictions.

1 *The Global Risks Report 2019* is available at: https://www.weforum.org/reports/the-global-risks-report-2019 (last accessed 4 February 2019).

2 Expected impacts of a 1.5°C global warming include, among others, increased water scarcity, with 4 per cent more people exposed to water stress; altered ecosystems, including up to 90 per cent of coral reefs at risk from bleaching; aggravated risk of flooding in coastal regions, with 31 to 69 million people exposed; significant decrease in crop yield, exposing 32 to 36 million people to food availability issues.

3 See https://www.fsb-tcfd.org/publications/ (last accessed 14 February 2019).

4 The Guardian (15 October 2018), *Superdry issues profit warning after sales fall in heatwave*.

5 This was the case with America's largest two energy companies, ExxonMobil and Chevron. After the historic Paris Agreement came into force in 2016, the two companies were faced with unprecedented investor pressure over climate change disclosure.

6 IEA-IRENA, *Perspectives for the energy transition*, available at: https://www.iea.org/publications/insights/insightpublications/PerspectivesfortheEnergyTransition.pdf (last accessed 4 February 2019);
GFI, *Accelerating Green Finance*, available at: http://greenfinanceinitiative.org/wp-content/uploads/2018/03/Accelerating-Green-Finance-GFT-FINAL-report.pdf (last accessed 4 February 2019);

7 Imperial College Business School and SOAS University of London, *Climate Change and the Cost of Capital in Developing Countries*, available at: https://eprints.soas.ac.uk/26038/1/ClimateCostofCapital_FullReport_Final.pdf (last accessed 4 February 2019);

8 The objective to promote environmentally sound and sustainable development through its activities lies at the heart of the EBRD's mandate: Article 2(1)(vii) AEB.

9 Lliuya v RWE AG, Case No. 2 O 285/15 Essen Regional Court (2015).

10 People of the State of New York v Exxon Mobil Corporation, 452044/2018 N.Y. Sup. Ct.

11 Urgenda Foundation v The State of the Netherlands, C/09/456689/HA ZA 13-1396.

12 Bank of England Prudential Regulation Authority, Consultation Paper 23/18 (October 2018), *Enhancing banks' and insurers' approaches to managing the financial risks from climate change*, available here: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change (last accessed 13 February 2019).

"In the coming years, business success will be strongly associated with how well climate risks and opportunities are integrated into core business and strategic planning."

13 European Commission, Technical Expert Group on Sustainable Finance (January 2019), Report on climate-related disclosures, Brussels.

14 See https://www.cdp.net/en/info/about-us (last accessed 4 February 2019);

15 UNEP-FI, *Navigating a new climate: Assessing credit risk and opportunity in a changing climate: Outputs of a working group of 16 banks piloting the TCFD Recommendations*, available here: http://www.unepfi.org/wordpress/wp-content/uploads/2018/07/NAVIGATING-A-NEW-CLIMATE.pdf (last accessed 4 February 2019).