December 2020

Management Liability Risk Insights

Climate Change: challenging, yet full of opportunity

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The following is the first in a series of risk insight articles on the challenges and opportunities for companies and their management in addressing evolving risks.

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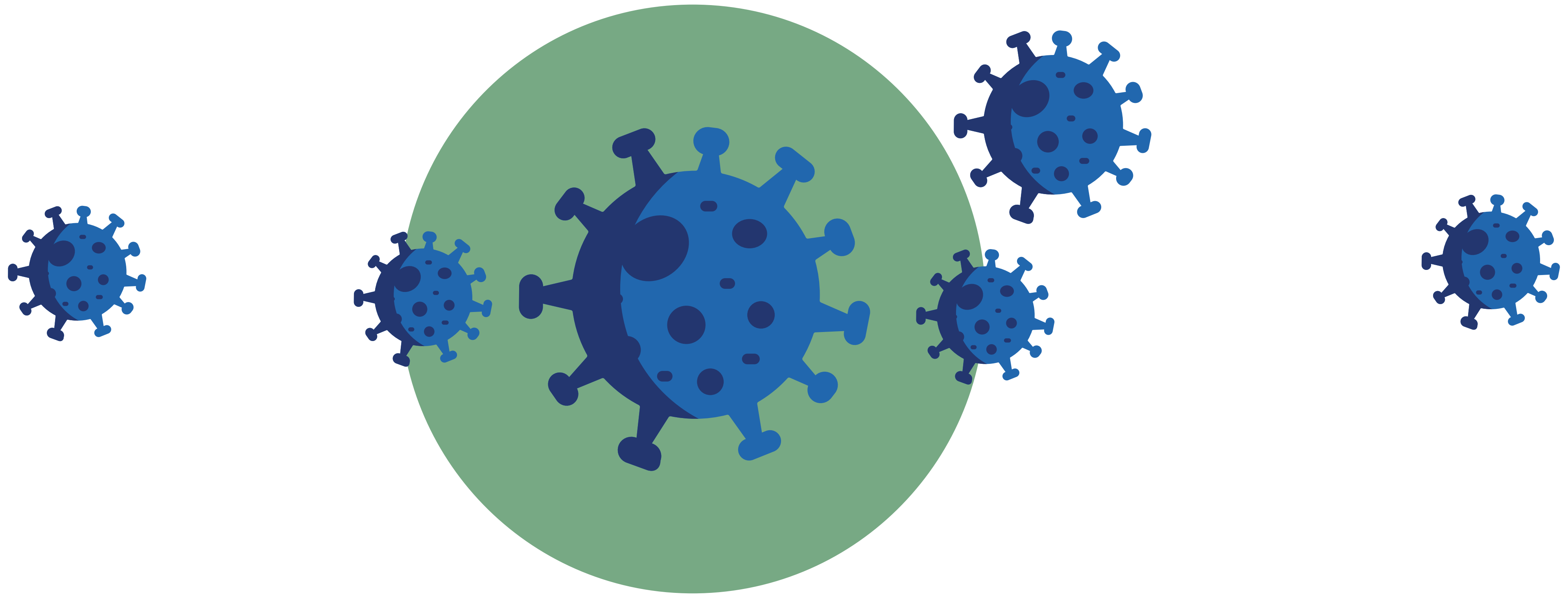
Climate Change ‘top’ area of concern

The expectation was that ‘the net-zero future’ would be one of the most talked about risk issues at Boardroom level in 2020, but of course this has been the most unpredictable of years. Climate change is consistently rated as one of the top areas of concern for risk managers and business owners. In the 2020 edition of the World Economic Forum’s (WEF) Global Risk Report, environmental risks dominated the top long-term issues listed by likelihood among members of the WEF’s multi-stakeholder community.[1]



While the impact of COVID-19 has, understandably, brought about a temporary shift in focus, climate change risks have not abated. In fact, direct parallels can be drawn between the impact of a global pandemic and that of climate change. This is focusing minds on how best to mitigate the risks of climate change, and how to adapt to an increasing environmental, social and governance (ESG) regulatory environment, while also taking advantage of potential opportunities now available to choose a strong green stimulus route in coming out of the pandemic.

ESG issues and regulation are a priority for shareholders, and there is an increasing desire to ensure that companies are factoring environmental, social and governance elements into their long-term strategy. While ESG encompasses many facets beyond climate change, the global focus on this specific area of risk (and opportunity), and the desire to ensure that businesses are ‘playing their part’ in what is a global climate crisis, has arguably put climate change and resource scarcity at the center of the ESG debate.

[1] Global Risks Report 2020, https://www.weforum.org/reports/the-global-risks-report-2020

[2] The Business Ambition for 1.5°C campaign is an urgent call-to-action for companies to set emissions reduction targets in line with a 1.5°C future, backed by a global network of UN agencies, business and industry leaders.

The transition to a low-carbon economy is under way and accelerating globally, with companies increasingly committing to science-based targets. Led by the Science-Based Targets initiative (SBTi), companies joining the Business Ambition for 1.5°C campaign[2] commit to emissions reduction targets across their operations that are determined by scientists to be consistent with keeping global warming to 1.5°C above pre-industrial levels. SBTi reports that 1,052 companies are already taking science-based climate action, and that 541 of these have science-based targets approved and published by SBTi. These companies are not only proving that a 1.5°C-compliant business model is possible, they will also be well placed to thrive as the global economy transitions to a net-zero future by 2050.

Climate change is a core business risk, and regulators and investors are taking an ever-increasing interest in the implications of global warming; what they want to see is companies understanding climate change risks (physical, transitional and liability), and the unique challenges posed, depending on their geographical location and industry sector of operation.

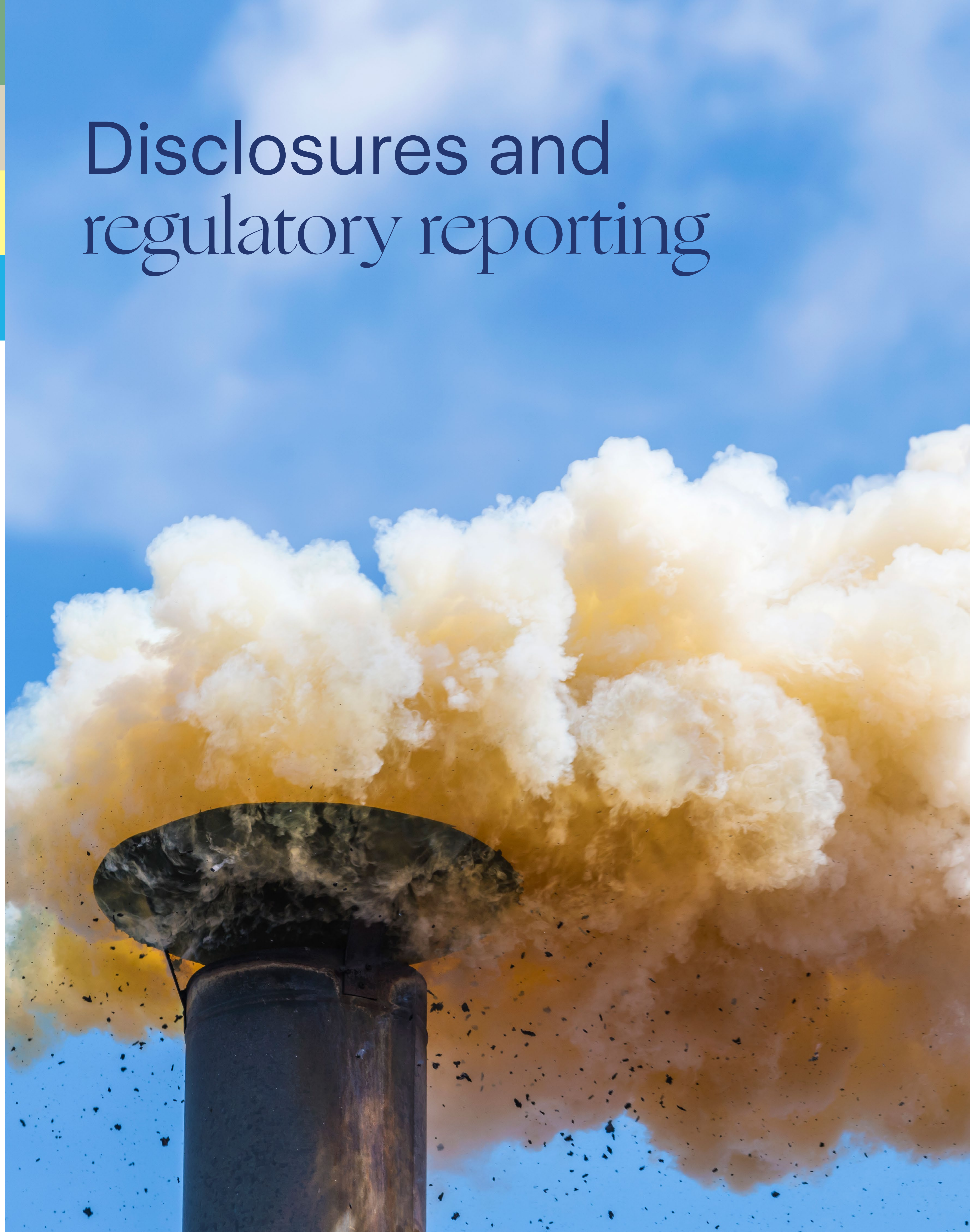
The benefits of ensuring an early, decisive transition to a carbon-neutral economy are well documented. For example, the Bank of England cites the "Early policy action scenario" leading to limited macroeconomic shock provided government policies are well signposted and implemented smoothly, with financial markets pricing in the cost of transition in an orderly fashion, and taking advantage of opportunities as they arise.[3] The Bank also notes that the "window for an orderly transition to a carbon-neutral economy is finite and closing", highlighting the need for urgent measures to contain the expected rise of global average temperatures over the coming decades.[4]

[2] The Business Ambition for 1.5°C campaign is an urgent call-to-action for companies to set emissions reduction targets in line with a 1.5°C future, backed by a global network of UN agencies, business and industry leaders.

[3] Bank of England 2021 Biennial exploratory scenario on the financial risks from climate change, https://www.bankofengland.co.uk/-/media/boe/files/paper/2019/the-2021-biennial-exploratory-scenario-on-the-financial-risks-from-climate-change.pdf, 2019
Providing an update on PRA and FCA climate change and green finance initiatives, https://www.fca.org.uk/publication/corporate/climate-financial-risk-forum-guide-2020-summary.pdf

[4] Idem

Disclosures and regulatory reporting



In order to make sure businesses are taking the risks of climate change into account, there is a real focus on ensuring transparency by way of reporting on the impact of such risks. In 2017, the Task Force on Climate-related Financial Disclosures (TCFD) published a voluntary set of disclosures to help inform investors of the risks of climate change. According to its October 2020 Status Report, companies' disclosure of the potential financial impact of climate change on their businesses and strategies remains low.

The report stated that only one in fifteen of the companies reviewed disclosed information on the resilience of their climate risk strategy—far lower than other categories of disclosure, including governance and risk management.[5] The TCFD has since published guidance on scenario analysis for non-financial companies, in an effort to assist those companies who are finding the TCFD strategy recommendations challenging to implement.[6]

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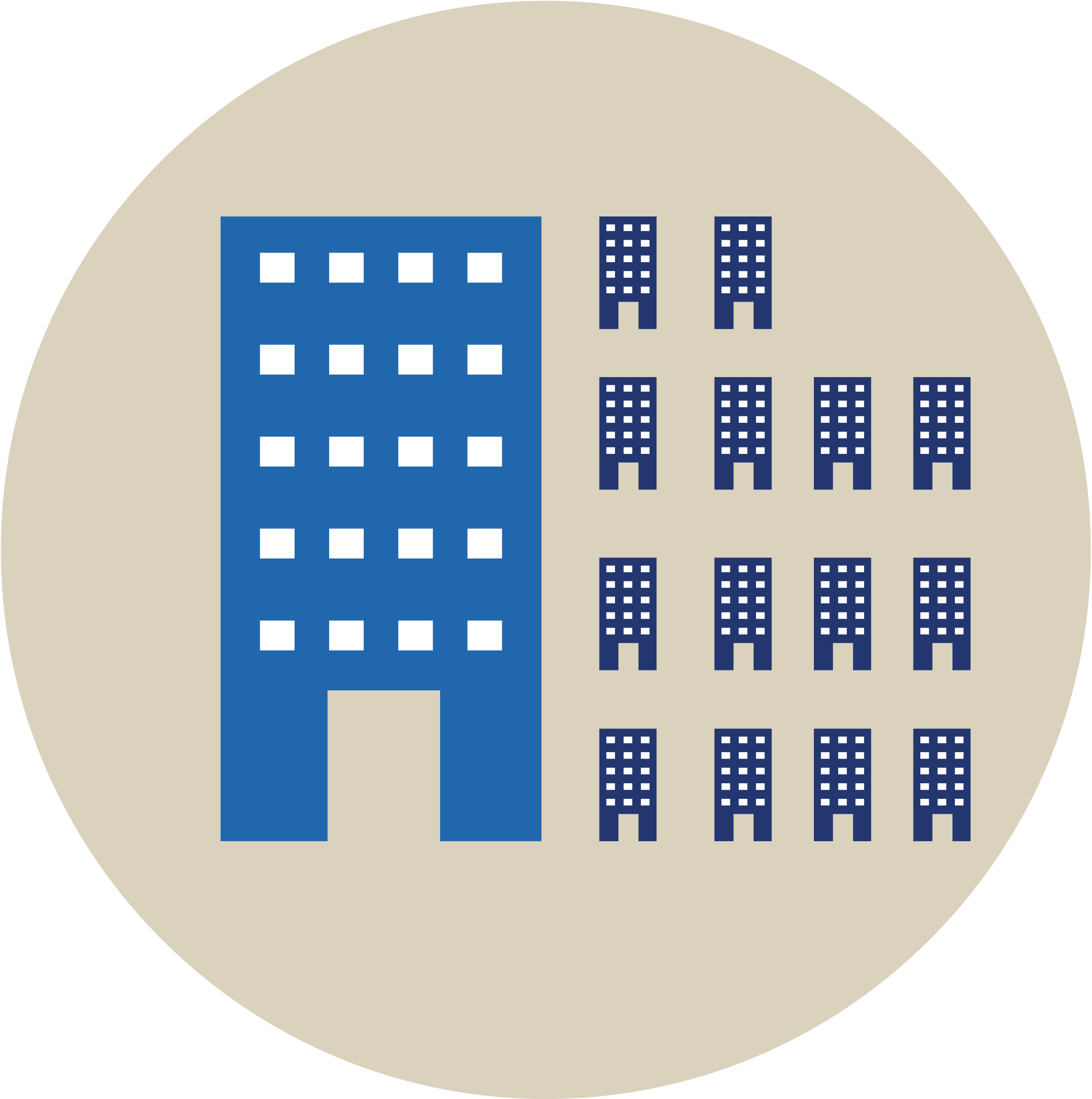
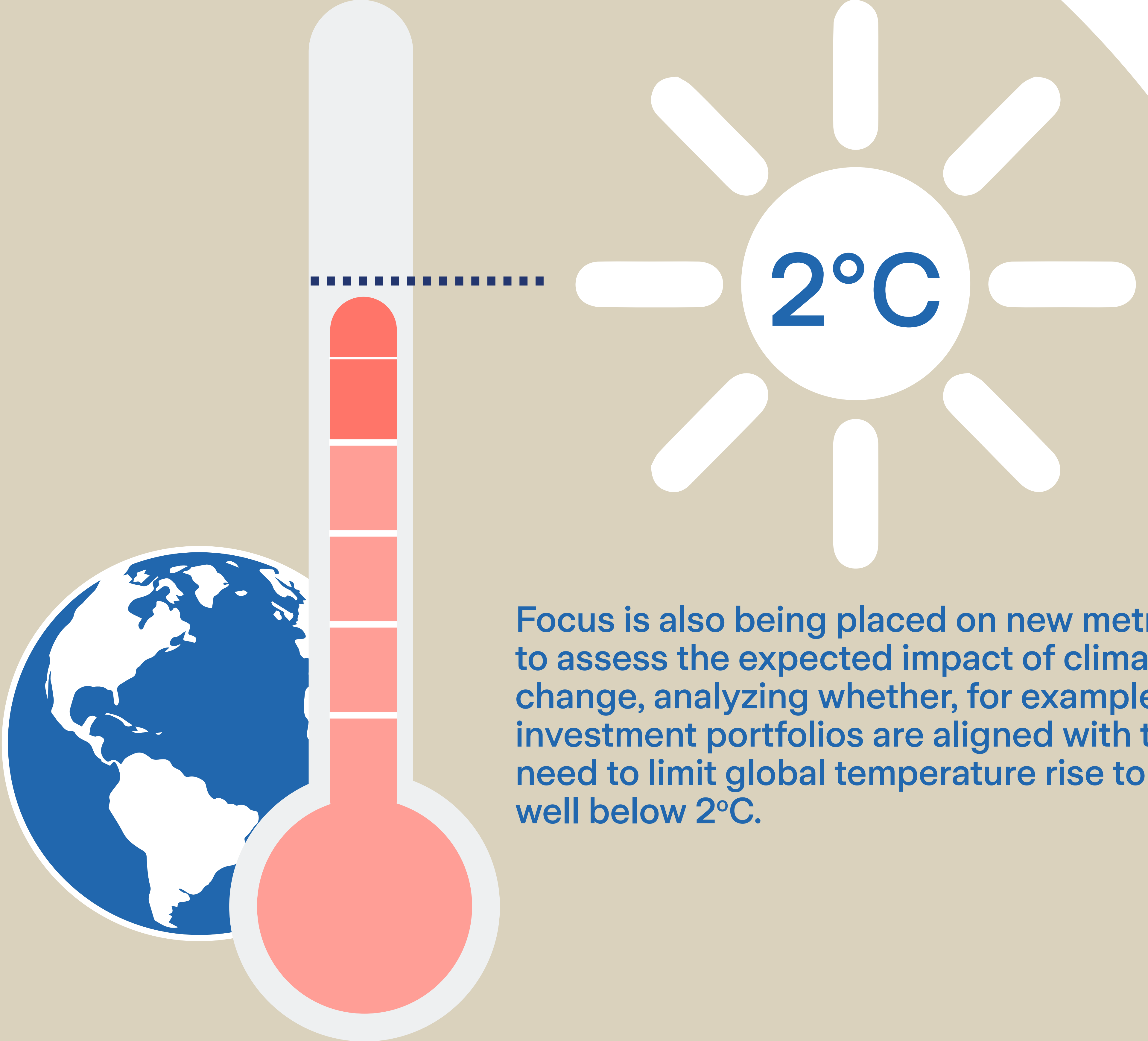
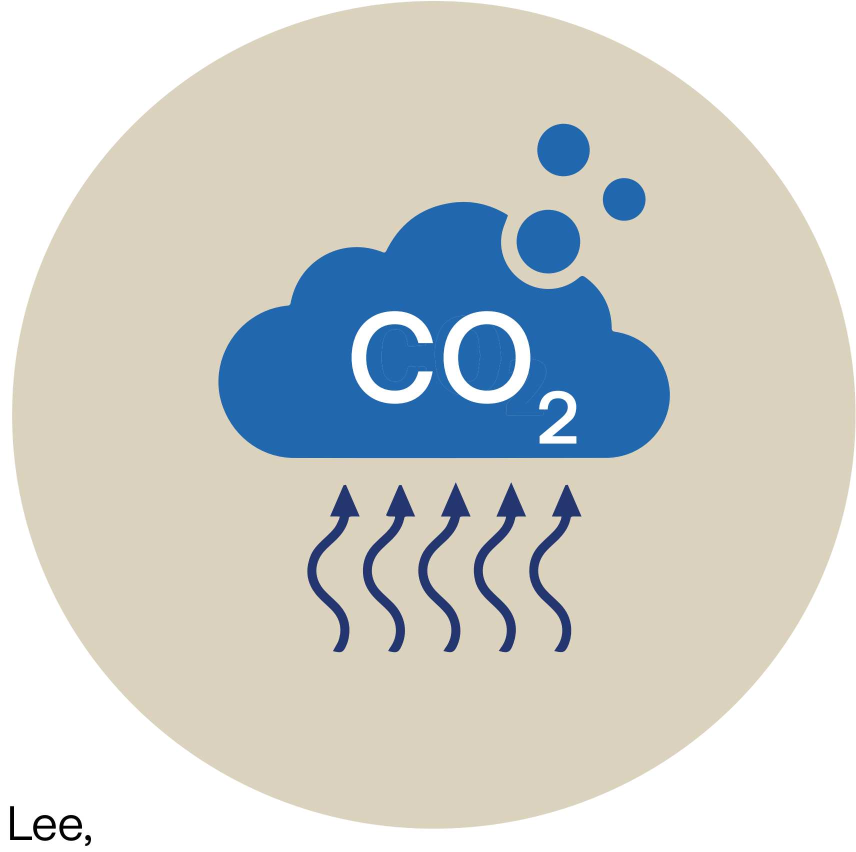


[5] Task Force on Climate-related Financial Disclosures 2020 Status Report

[6] https://www.fsb.org/wp-content/uploads/P291020-3.pdf



Focus is also being placed on new metrics to assess the expected impact of climate change, analyzing whether, for example, investment portfolios are aligned with the need to limit global temperature rise to well below 2°C.



Unsurprisingly, calls are also being made for more consistency and comparability in financial reporting. In a November 5th, 2020 speech delivered by the US Securities and Exchange Commissioner, Allison Herren Lee, she highlighted the need for standardized climate change disclosure standards, leveraging the work of the TCFD, in order to assess and address the potential systemic risks to financial markets and our economies posed by climate change.[7] She drew a parallel between the failure to prepare for the pandemic, when we knew the potential risk existed, with the need to address the looming real risks arising from climate change. The overall expectation is that climate change disclosure and reporting will be mandatory in many jurisdictions, with several major jurisdictions implementing TCFD recommendations.[8] The Bank of England confirmed as such in November 2020.[9]

Focus is also being placed on new metrics to assess the expected impact of climate change, analyzing whether, for example, investment portfolios are aligned with the need to limit global temperature rise to well below 2°C. One measure being considered is the implied temperature risk (ITR) associated with investments, whereby an estimate is provided of the global temperature rise associated with greenhouse gas emissions of a company, investment strategy or fund. While a new and evolving metric, ITR demonstrates the symbiosis between advances in science that provide the information for calculating such measures, and the increasing regulatory framework needed to ensure a unified and consistent approach to disclosure about climate risks in financial metrics, so as to avoid an abrupt policy response in the lead-up to the 2015 Paris Agreement's 2050 deadline.[10]

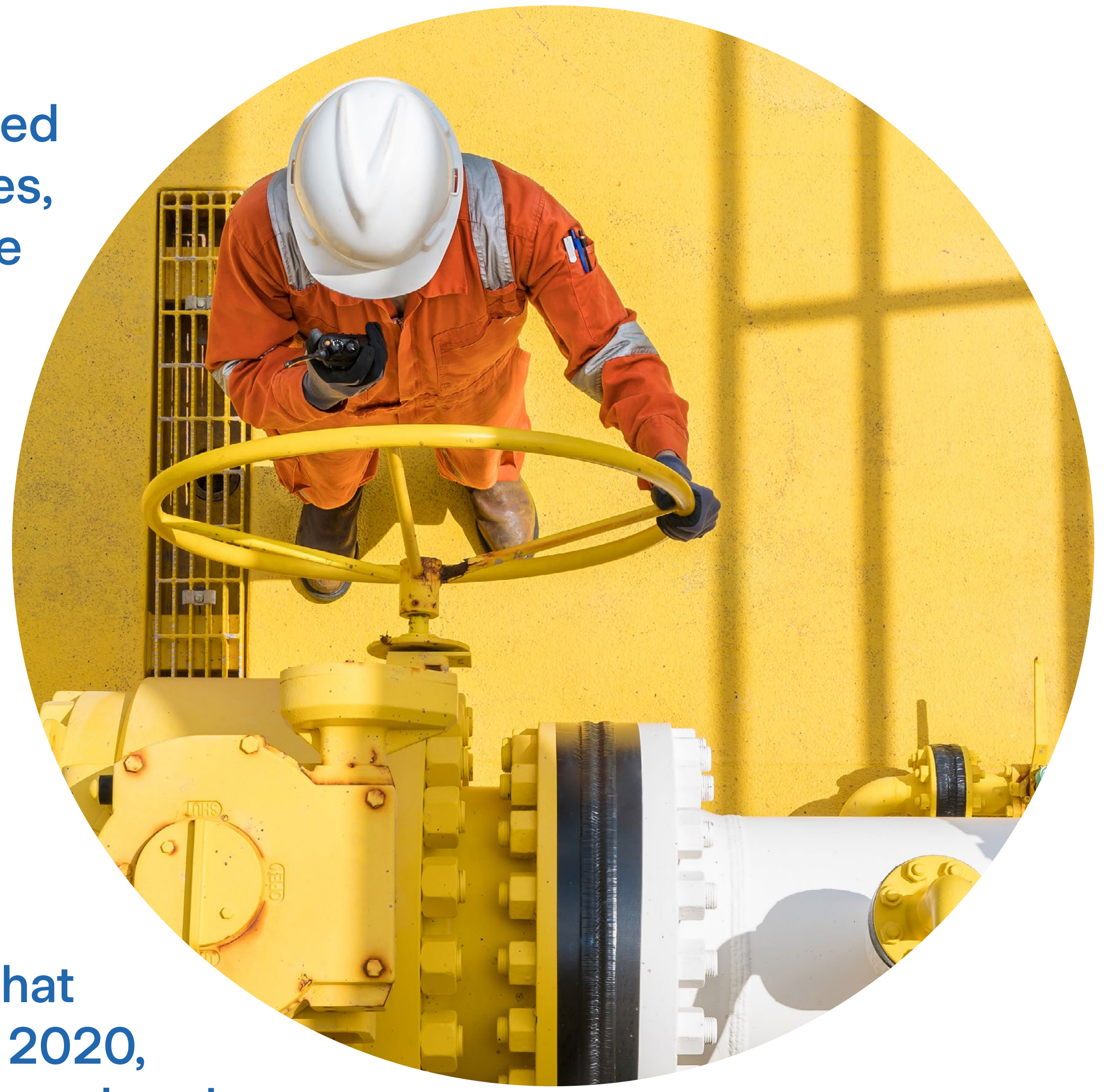
[7] Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation, Keynote Remarks at PLI 52nd Annual Institute on Securities Regulation, https://www.sec.gov/news/speech/lee-playing-long-game-110520

[8] CDP_Climate_Change_Policy_brief_2020.pdf

[9] HM Treasury (2020): A Roadmap towards mandatory climate-related disclosures. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/933783/FINAL_TCFD_ROADMAP.pdf

[10] The Paris Agreement falls within the United Nations Framework Convention on Climate Change and was agreed in 2015 at the 21st Climate Change Conference.

Developing climate-related litigation



Climate-related litigation has increased significantly over the last two decades, with the overwhelming majority of the reported cases, both within and outside of the United States, occurring from the mid-2000s onwards, reflecting the increasing awareness and focus on the impact of climate change.[11] In its "Global trends in climate change litigation: 2020 snapshot", the Centre for Climate Change Economics and Policy tracked 1,587 such cases worldwide, 374 of which were filed outside the US. It reports that for the period from May 2019 to May 2020, the major trends in litigation strategies related to the use of human rights arguments to support claimant demands, and different approaches being used to bring lawsuits against the major fossil fuel companies, including claims for fraud and disclosure-related lawsuits, particularly in the US.[12]

Although climate change-related litigation has been predominantly against governments in the past, litigation against companies has recently increased, with allegations often based upon company law obligations, and with the objective of compelling climate-friendly action. It is interesting to note that more of these cases affecting the financial sector were filed in 2019 than in any previous year.[13] Certain cases arose from financial investments in the fossil fuel industry, while others involved shareholder claims against banks, pension funds and investment funds for failing to incorporate climate risk into their decision-making, and for failing to disclose climate risk to their beneficiaries. In reviewing the Sabin Center for Climate Change Law Litigation database, we note that from 2007 onwards, 35 of the US cases involved allegations against companies relating to Securities and Financial Regulations, including claims specifically relating to the failure to disclose, or misrepresentations in disclosures. Of the non-US lawsuits, 43 are identified as cases against companies, with seven of these relating specifically to disclosure allegations.[14]

[11] Global-trends-in-climate-change-litigation_2020-snapshot, Centre for Climate Change Economics and Policy, https://www.lse.ac.uk/granthaminstitute/publication/global-trends-in-climate-change-litigation-2020-snapshot/

[12] Idem.

[13] 2020 Snapshot.

[14] Climate Change Litigation Databases, 2020 Sabin Center for Climate Change Law, http://climatecasechart.com/

Claimant law firms are assessing commitments made by businesses, and disclosures made are heavily scrutinized. A noteworthy settlement was reached in early November 2020, in the action brought by plaintiff Mark McVeigh against an Australian pension fund, REST (Retail Employees Superannuation Trust). The case, which was filed in the Federal Court of Australia in 2018, centered around allegations that the fund violated the Corporations Act 2001 in failing to provide information related to climate change business risks and any plans to address such risks, such that beneficiaries were unable to make informed decisions about the management and financial condition of their investments. Further allegations were made that the fund violated the Superannuation Industry (Supervision) Act 1993 by failing to act with the care, skill and diligence required to perform the trustees' duties in the best interests of the beneficiaries.

Settlement was reached immediately before the start of the trial, with REST acknowledging that, consistent with the TCFD, "climate change could lead to catastrophic economic and social consequences, and is an important concern of REST's members", referring to it as a "material, direct and current financial risk to the superannuation fund across many risk categories, including investment, market, reputational, strategic, governance and third-party risks". **As such, REST has committed to several new initiatives to ensure that its policies manage climate change risks, and to disclose such risks to members.** While not binding authority, the policy and initiatives set out in this case provide guidance for other investment funds seeking to protect themselves against similar claims.

With the increased focus of regulators to ensure that businesses provide necessary disclosures, climate-related litigation will also continue to increase. In particular, the potential attraction of 'agenda-setting litigation'—where there is a desire to hold companies and their Boards to account for their contribution to climate change—means that directors need to ensure that they are not opening up either themselves, or their business, to a potential claim. **The Bank of England's Prudential Regulation Authority (PRA) has provided a useful grouping for such pieces of litigation, namely 'failure to mitigate', 'failure to adapt', and 'failure to disclose or comply'**[15]. Where we are seeing particular growth in litigation is under the last of these categories, which can in fact be broken down further to 'failure to disclose or to adequately disclose'.

There is certainly a drive to focus on companies which are not providing adequate disclosure to demonstrate that they are considering the transition to a carbon-neutral economy. A rise in these types of claims sits against the backdrop of a report published in November 2020 by a Swiss Bank, J. Safra Sarasin. This report found that companies are failing to respond to investor demands on climate change, such that few public companies are likely to meet the targets of the 2015 Paris Agreement. According to the analysis, which focuses on the past, current and future emissions of 6,000 groups, businesses worldwide appear to be on course for a 4°C global temperature rise, while in Europe the number stands at 3.5°C. This is despite widely circulated reports that large institutional investors are seeking to hold directors accountable through proxy voting, if they believe a company is not making adequate progress towards ESG reporting. In fact, earlier this year, the ISS (Institutional Shareholder Services group) published its climate-focused specialty proxy voting policy to provide a model for the assessment of a company's climate-related performance, and disclosures to inform climate-based proxy voting recommendations.[16]

[15] Bank of England PRA, "The impact of climate change on the UK insurance sector, A Climate Change Adaptation Report by the Prudential Regulation Authority", September 2015

[16] https://www.issgovernance.com/file/policy/active/specialty/Climate-International-Voting-Guidelines.pdf

The opportunity to build stronger, more resilient and environmentally responsible businesses

The evolving nature of regulatory and sector guidance on climate change—and the presence of climate-action firms that seek to persuade or compel businesses considered not to be taking the risks of climate change seriously—understandably puts pressure on management. This is the case, not least given the significance of the risk that needs to be addressed. It is, however, important to remember the potential opportunities that stem from such a challenge.

As climate change and its associated risks continue to evolve rapidly, assessing resilience and responding accordingly remains essential for all companies. For business leaders, this process may yield benefits beyond investment in improving the physical resilience of assets, and in developing alternatives to existing supply chains, utilities and business processes. A truly holistic review of climate-related risks can also reveal potential business opportunities in diversifying to low-emissions products and services, as well as the potential for better competitive advantage in responding to shifting consumer preferences.

In its 2019 report, ‘Major Risk or Rosy Opportunity...?’, the Climate Disclosure Project (CDP) found that 225 of the world’s 500 biggest companies recognize that climate-related opportunities represent potential financial impacts totaling over US$2.1 trillion, referencing the drive towards increasing revenue as a result of demand for low-emissions products and services. Interestingly, almost all of these opportunities were reported to be “likely, very likely or virtually certain” [17], with the majority said to materialize in the short- to medium-term. In its more recent calculations, the CDP estimates the global market for low-carbon goods and services at US$5.5 trillion.[18]

[17] Major risk or rosy opportunity, are companies ready for climate change?” CDP 2019
[18] https://www.cdp.net/en/climate

The current pandemic provides valuable lessons on the benefits of developing shorter supply chains, videoconferencing instead of business travel, and increased digitization of sales and marketing.

In conclusion, companies and their management need to seize the moment to assess and quantify the impact of climate change and capture opportunities to make their operations more resilient and more sustainable, as well as to transition to more sustainable products and services. The current pandemic provides valuable lessons on the benefits of developing shorter supply chains, videoconferencing instead of business travel, and increased digitization of sales and marketing. Some of these practices and behaviors may well continue, becoming the “new” or “next” normal, and form important components of a company’s sustainability transformation—one that accompanies the cost-efficiency and digital-transformation efforts that are likely to be undertaken across various industries in the wake of the pandemic.[19] **Ultimately, any organization that puts climate change within its key management objectives, and ensures that climate change risk analysis is integral to its strategy and risk discussions—with adequate resource and expertise to address such risks—will ensure a smoother transition to a carbon-neutral economy, mitigate the risk of climate-related litigation, win the support of investors, and improve shareholder value.**

[19] The Next Normal, How companies and leaders can reset for growth beyond coronavirus www.mckinsey.com/featured-insights/coronavirus-leading-through-the-crisis

For further information on these developing topics, please note the following publications:

Managing the impacts of climate change: risk management responses
Second edition, Zurich White Paper on Climate Change. September 24, 2019

Task Force on Climate-related Financial Disclosures 2020 Status Report

UK joint regulator and government TCFD Taskforce: Interim Report and Roadmap
9 November 2020

Reports and guidance published by the Climate Measurement Standards Initiative (CMSI)

which include "Scenario analysis of climate-related physical risk for buildings and infrastructure: Financial disclosure guidelines & climate science guidance". The CMSI is an Australian industry-led collaboration established to assist with, and support, climate-related financial disclosures.

CDP Climate Disclosure Project ('CDP') Policy Briefing

"The Time for Action is Now – Recommendations for policymakers to incentivize corporate climate action" 2020, highlighting the need for mandatory regulatory disclosure to foster transparency from all economic actors. "Requirements that embed the TCFD recommendations within national jurisdictions would create multiple economic benefits, help to accelerate the zero-carbon and climate-resilient transition, and ensure management of risks is embedded within the real economy".

CDP Climate Change 2020 Reporting Guidance

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