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Disclosure of Climate Change Risks

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Abstract: Climate change not only represents a global environmental problem, but for many organizations, it also has grave financial impact. This paper explores whether climate change presents a new class of non-financial risk, and gives arguments for why it should be recognized as a non-financial risk. The paper explains the importance of transparency on climate risk disclosures for directors and considers the ethics of deciding to ignore climate change as a non-financial risk and failing to disclose organizations' vulnerability to climate change.

Introduction

It is widely accepted one of the main reasons for the Global Financial Crisis (GFC) is a lack of ethical governance practice and accurate financial disclosure. Therefore, corporations are now under much greater expectation and pressure to provide consistent, timely and correct information to shareholders regarding financial performance and in particular, the risk to that performance. If investors are to make informed judgments of the risks and rewards of any investment, this information is critical to justify their decisions (Fung, 2014).

The importance of these disclosures cannot be underestimated - since the GFC, stakeholders are paying more attention to the process and content of disclosure. This reporting has been at the forefront of establishing a new social paradigm, which seeks to balance the ethics of reducing unscrupulous corporate practice whilst preserving a competitive business environment (Fung, 2014). Extensive disclosure enables investors to be aware of ethical aspects of business practices and their consequences (Hoje, 2007).

The Relationship Between Ethical Conduct and Corporate Disclosure

Business ethics is related to the moral philosophy, values and norms of behavior that guide a corporation's decision-making processes. Ethics concerns formalized principles and codes of conduct as well the value systems of society that guide how people behave and address ethical situations that may arise in the conduct of business (Francis, 2003).

The Organization for Economic Co-operation and Development (OECD) has established that investor confidence and market efficiency depend on the disclosure of accurate timely information about corporate performance. To be of value in global capital markets, disclosed information should be clear, consistent and comparable (OECD, 1998).

A key pillar to the notion of ethics as established by the OECD is the dissemination of information and the transparency behind this reporting. This is because a shareholder has a financial stake in a company's successes and failures and therefore has a legitimate right to know an organization's understanding of corporate strategy, including strategic risks and possible investment vulnerabilities (Hummels, 2004). This right extends beyond the established right to financial information on a quarterly or yearly basis to non-financial performance and the portfolio's risk exposure to include non-financial factors, as these can directly impact upon a company's financial position (Repetto, 2000).

Does Climate Change Qualify as a Non-Financial Risk?

Global climate change presents the most complex and uncertain environmental challenge facing all stakeholders in the financial sector, including governments. However, given the multi-faceted nature of the challenge, estimates of the financial impact have been difficult to assess accurately.

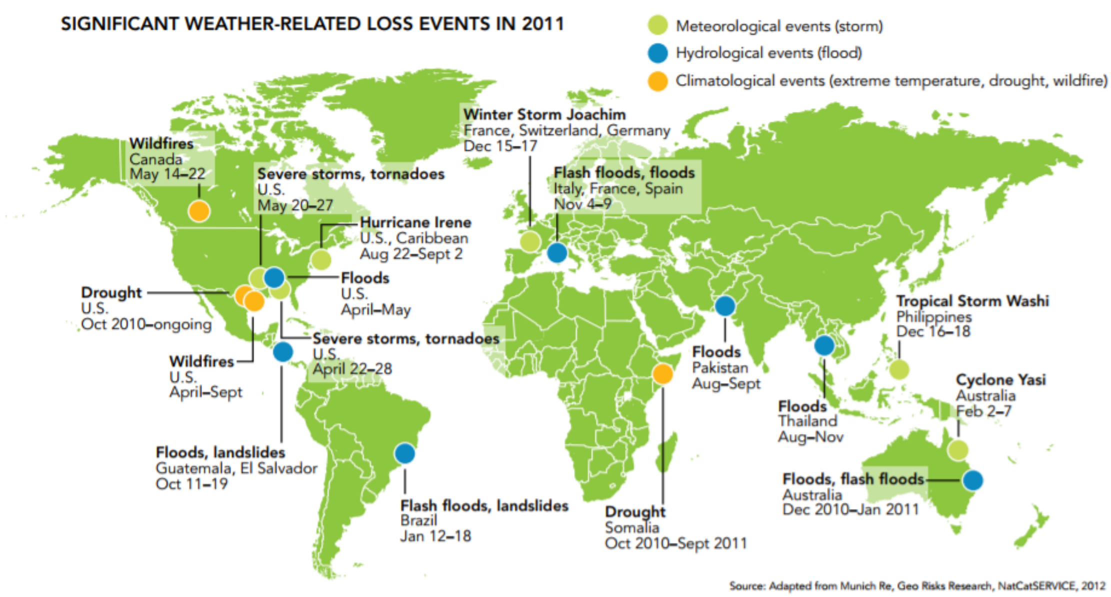
Tentative estimates have valued a loss of $33 trillion under a "business as usual (BAU)" scenario, demonstrating the magnitude of the risk (UNDP, 2016). There are concerns this loss will not be distributed equally and will only further drive global economic inequality, with the poorest third of countries expected to experience losses between 2 – 20% of GDP under the BAU scenario (Hsiang, 2017).

Defining Climate Risk

There are now three categories of risk climate change presents to an organisation.

a. Physical Risk

It has long been established climate change presents a physical risk to an organisation through the exacerbation of weather events (Oxfam, 2012). Globally, in 2011 losses suffered from significant weather reached $148 billion (Höppe, 2012) with an additional $55 billion in insured losses (Oxfam, 2012). The map below demonstrates the events that contributed to a considerable proportion of the losses and highlights how widespread this risk is.



Since the critical United Nations Climate Change Conference (COP 21) the emergence of two new risks "categories" have emerged, *transitional* and *liability risk* (Oxfam, 2012).

b. Transitional Risk

Transitional risks essentially reflect the recognition that governments must change policies and regulatory structures to meet targets set under COP21. To reach these goals, governments must not allow more than two thirds of coal, oil and gas reserves to be burnt before 2050 (IEA, 36), essentially leaving them as a standard asset[1].

> *A stranded carbon asset will remain untouched to meet carbon dioxide commitments under the Paris Agreement, this includes Gas, Oil and Coal. It is estimated this cost will be over 1 trillion dollars in assets. Leaving these assets untouched will fundamentally alter existing business models (IEA, 2013).*

Climate-Related Financial Disclosures (TCFD) categorised transitional risks as (TCFD, 2016);

- **Policy change**: To address climate change and drive a transition to a low carbon economy; in turn, these new laws may give rise to new forms of litigation.
- **Technology:** The uptick in low carbon technology, which can result in operational and processing changes along with the associated financial cost.
- **Market:** A change in the viability of a business model built upon extracting natural resources.
- **Reputational:** Damage to a reputation arises from the association to a particular asset or company.

c. Liability Risks

The notion that Climate Change presents a liability risk to companies is one that remains relatively speculative. However, as previous liability risks such as asbestos (net costs of liability losses: $85 billion), tobacco and pollution have shown, they can be disruptive and financially costly if litigation is successful.

It is too simplistic to equate climate change litigation with the aforementioned areas of well-established liability. However, the success of the *Urgenda Found v The State of Netherlands* in 2015 was viewed as a significant turning point for the success of climate litigation. The precedent set from this case was to force an obligation upon a public institution (the Netherlands Government) to act upon climate change. This decision was a vital turning point in global climate change litigation. The outcome of this case required the Netherlands Government to reassess their Paris Agreement Nationally Determined Contribution and adjust upwards from 17% to 25% (The Hague, 2015).

> The court concluded that the state has a duty to take climate change mitigation measures due to the *"severity of the consequences of climate*

> *change and the great risk of climate change occurring* (The Hauge 2015).*"*

What will dramatically change the landscape of the prospective impact of liability risks is whether current "California Climate Cases" against oil and gas companies, including Exxon Mobile, BP and Shell are successful. While the defendants are firm in their resolve that this case is merely frivolous, if they were to succeed, it would mark a dramatic shift in the allocation of responsibility for climate change and the costs suffered by communities (McWilliams, 2017).

How the Financial Sector Views Climate Change Risk and the Importance of Disclosure

Although there is clear evidence regarding the threat of climate change risks, without legislative change from regulatory bodies there is no legal incentive for companies to monitor and report these risks. Indeed, in the early 2000's this was certainly the case. However, there has been a dramatic shift with regulators recognizing the existence of and need to report financial risks associated with climate change.

The 2015 speech delivered by the Governor of the Bank of England, Mark Carney, titled "Breaking the Tragedy of the Horizon", called for greater disclosure of climate risk and is widely acclaimed as a significant moment for the recognition of the risk of climate change (Carney, 2015);

> "*Of course, given the uncertainties around climate, not everyone will agree on the timing or scale of adjustments required to achieve this goal. But the right information will allow optimists and pessimists, sceptics and evangelists, to back their convictions with their capital* (Carney, 2015)."

It was also seen as the ignition to facilitate change in regulatory bodies' assessments of climate change and the risk it presents to the financial sector.

The speech coincided with another landmark moment in geopolitics, with the G20 Summit asking the Financial Stability Board (FSB) to consider climate risk. In response to this, the FSB launched a climate-related Financial Task Force which published its final recommendations in June 2017.

The taskforce recognised that one of the most significant, and perhaps most misunderstood, risks that organisations face today relates to climate change (TCFD, 2017).

> "*As part of its review, the Financial Stability Board identified the need for better information to support informed investment, lending, and insurance underwriting decisions and improve understanding and analysis of climate-related risks and opportunities. Better information will also help investors engage with companies on the resilience of their strategies and capital spending, which should help promote a smooth rather than an abrupt transition to a lower-carbon economy* (TCFD, 2017)."

Michael Bloomberg, chair of the Financial Task Force, summarized the findings of the report; "*increasing transparency makes markets more efficient and economies more stable and resilient"* (TCFD, 2017).

Given the role both Carney and Bloomberg play in the financial and corporate sectors, it would be hard for a company with shareholders to be unaware of these announcements and the recognition of the importance of climate risk disclosure.

The question now arises, has this recommendation been heeded by companies, and how many are now disclosing climate related financial risks?

Reception of this Acknowledgement by the Wider Sector

The corporate sector has partially embraced climate risk disclosure, with different organizations coming together to make voluntary disclosure projects. Examples are *The Carbon Asset Risk Initiative* (Foerster, 2017)*, Carbon Action Initiative* (Foerster, 2017) and *We Mean Business Coalition* (Foerster, 2017). While these projects are commendable concepts, most corporations do not participate in such voluntary disclosure projects.

It is generally established that climate change presents a material risk to every organization, and therefore industries should voluntarily inform shareholders of climate risk.

There are signs that corporate culture is evolving in this direction, as even companies who were historically reluctant to acknowledge the risk that climate change presents, such as Exxon-Mobil, have now accepted the risks. Further, they are on record as committed to the improvement of their disclosure processes (Exxon, 2017).

Despite this positive move, in a recent study conducted by KPMG, 72 percent of large and mid-cap companies worldwide do not acknowledge the financial risks of climate change in their annual financial reports (KPMG, 2017). Additionally, of the small percentage that do acknowledge climate-related risk, 4 percent provide investors with an analysis of the potential business value at risk (KPMG, 2017).

The KMPG study reviewed annual financial reports and corporate responsibility reports from the top 100 companies by revenue in each of 49 countries, a total of 4,900 companies. The findings demonstrated that among the world's 250 largest companies (G250), public acknowledgement of climate-related financial risk is common but far from universal. By geography, French-based multi-nationals lead with 90 percent admitting climate-related risk, followed by companies headquartered in Germany (61 percent) and the UK (60 percent) (KPMG, 2017).

By sector, around two-thirds of G250 companies in the Retail (67 percent) and Oil & Gas (65 percent) industries acknowledge the risk, but only around one third (36 percent) of major Financial Services firms do so. However, the research found only six G250 companies have informed investors of the potential financial impact of climate risk through quantification or scenario modelling (KPMG, 2017).

These findings, in addition to the trends highlighted in previous sections, illustrated a concerning paradox: regulatory organizations recognize the material risk climate change poses to companies and shareholders, but those very same organizations are fail to require companies to disclose this risk.

While it remains legal for companies to not make these disclosures, the more important question now arises, has it become unethical to deny shareholders the opportunity to access this critical information?

Case Study – Australia

Australia presents an intriguing case to explore and understand this paradox. With regulatory bodies accepting, embracing, and openly discussing the importance of addressing climate change as a material risk, and with a regulatory framework that requires disclosure of material risk, one could assume Australia would be a leader in climate risk disclosure. Geoff Summerhayes, Executive Board Member of the Australian Prudential Regulatory Authority, echoes Mark Carney,

> "*My point is that it's unsafe for entities or regulators to ignore risks just because there is uncertainty, or even controversy, about the policy outlook. Like all risks, it is better they are explicitly considered and managed as appropriate, rather than simply ignored or neglected.*"

Additionally, within Australia's current regulatory framework, there has been much discussion around liability that may arise. The Hutley Opinion is a position widely understood to be pivotal in connecting disclosure of climate risk with directors' legal duties (Hutley, 2016).

> *"It is likely to be only a matter of time before we see litigation against a director who has failed to perceive, disclose or take steps in relation to a foreseeable climate-related risk that can be demonstrated to have caused harm to a company (including, perhaps, reputational harm)* (Hutley, 2016)*."*

However, to use Carney's words, the "*liability horizon*" has arrived within Australia. In *Abrahams vs Commonwealth Bank,* two Commonwealth Bank shareholders brought a claim against the bank for its failure to disclose climate risk to their shareholders in annual reporting in 2016. The shareholders asked the Federal Court of Australia for a declaration that the bank violated the 2001 Act and for an injunction either "restraining the bank from continuing to fail to report" on climate change-related risks and its responses, or requiring the bank to report on them.

Unfortunately, this test case did not proceed to trial, as Commonwealth Bank made climate risk disclosures in their 2017 reporting. But critically, what it did show was the willingness to hold corporations to account for their failure to disclose climate risk in Australia. Not only is there pressure from the top from regulatory bodies, but also from the bottom in the form of shareholders, for a company to actively and voluntarily disclose its exposure to climate change.

However, it remains to be seen if other companies will see the storm brewing on the horizon. Corporate Sustainability Reporting by the Australian Council of Superannuation Investors showed a clear failure to disclose climate change related information; critically, 70 out of the 200 did not make a single climate-related disclosure (Davidson, 2017).

This disappointing figure did not go unnoticed, with Louise Davidson, Chief Executive of ACSI commenting, "It's unlikely that 70% would have no climate change exposure (Davidson 2017)."

It now raises the question, are the actions of these companies not only placing them in a position of legal liability, but also an unethical position?

Conclusion

The ethics behind a voluntary disclosure of risk are well-established and are important to maintaining an equal and ethical global operating environment. Climate change, while a non-financial risk, is an established risk which can impact the profitability for shareholders and should be disclosed.

Denying shareholders the ability to make an informed decision with their investment is potentially leaving them vulnerable to suffering loss. It is unethical to make a deliberate decision to not disclose this information as the risk climate change presents, both currently and in future, is one that cannot be mitigated but must be adapted to.

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