Governance Challenges 2017

# Board Oversight of ESG

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# A Framework to Assess and Disclose the Impact of Climate Change on Financial Performance

**Marsh & McLennan Companies**

*The risks related to climate change and the opportunities for transitioning to a low-carbon economy are having a greater impact on core corporate strategies and operations. In this evolving business landscape, companies face pressure to understand and disclose the effects of climate-related risk on financial performance. Boards of directors, in their role of risk oversight, must ensure that climate-related threats are being considered in management's enterprise risk management programs and in strategic and operational planning.*

## A growing need to understand the financial impact of climate risks

Many companies are responding to pressure from shareholders and other stakeholders to disclose more information about the impact of their operations on the environment. Approximately 75 percent of the companies that make up the Standard & Poor's 500 Index produced sustainability reports in 2015, and roughly 6,000 companies worldwide provide climate data on the CDP's (formerly the Climate Disclosure Project) global disclosure platform regarding their greenhouse gas emissions.[1]

However, as the direct and indirect impact of climate-related risks grow in number and severity companies face additional pressures to disclose not only how the company is impacting the environment but also to provide clear information on how climate change may affect corporate performance. This demand is not necessarily new. Since 2010, the U.S. Securities and Exchange Commission (SEC) has called on publicly traded companies to disclose in their annual filings how climate change can impact the organization or present material risks.[2] However, the quantity and quality of disclosure vary greatly.[3] At the same time, investors are demanding that companies disclose the links between corporate performance and climate risks. In 2016, in the aftermath of the COP 21 meeting, 89 climate-change shareholder resolutions were filed, as shareholders voiced their concern over climate-change risk.[4]

In many instances, investors are dissatisfied with companies' current sustainability reports. While the reports provide much information on the sustainability efforts of the company (such as cutting water usage or reducing greenhouse gas emissions), they are often lacking in terms of the impact of climate threats on financial performance and how the company plans to respond strategically and operationally. As a result, the information is inadequate for making investment and capital allocation decisions.[5] The current status is a sore point with investors and other stakeholders, who are seeking to assess their own exposure to climate risk and expect the companies they invest in to do the same.[6]

Internally, companies struggle with reconciling sustainability reporting and financial reporting. Slow-moving climate-related risks and their potential effects are often difficult to identify and quantify, and in many cases they do

1 See CDP data at https://www.cdp.net.

2 SEC Interpretive Guidance on climate change disclosure became effective in February 2010.

3 *Environmental Disclosure Committee Newsletter*, American Bar Association, Vol. 13, No. 1, May 2016, p. 11. http://www.americanbar.org/content/dam/aba/publications/nr_newsletters/ed/201604_ed.authcheckdam.pdf

4 "Proxy Season Preview: U.S. Environmental & Social Issues," Institutional Shareholder Services Inc. (ISS). https://www.issgovernance.com

5 Emily Chasen, "Investors Want More From Sustainability Reporting, Says Former SEC Head," *CFO Journal* (blog), Nov. 12, 2015. http://blogs.wsj.com/cfo/2015/11/12/investors-want-more-from-sustainability-reporting-says-former-sec-head/

6 For example, Mercer has partnered with many large pension funds to examine the impact of different climate scenarios on their long-term investment performance. See: https://www.mercer.com/our-thinking/investing-in-a-time-of-climate-change.html

not align easily with corporate planning timelines. Companies may lack a clear-cut structure for integrating these risks effectively into their strategic and operational risk decision-making process.[7]

The recently released draft recommendations report from the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD) is an important step toward addressing these challenges and concerns.[8] Initiated at the request of the G20 Finance Ministers and Central Bank Governors, the TCFD, chaired by Michael Bloomberg, was an industry-led effort, with 32 global members representing experts from the private sector and covering a broad range of industries and financial markets.[9] The goal of the proposed disclosures—designed to be applicable to all organizations in all industries—is to support the reporting of climate-related risks and opportunities in financial filings. This will provide relevant, forward-looking information to investors, lenders, and insurance underwriters on the potential financial impact of climate-related risks and opportunities, and what is being done to manage them.

The TCFD recommendations focus on disclosures related to the financial impact of climate change on the company's bottom line—not on a company's impact on the environment and climate. The recommendations reinforce existing reporting requirements in most G20 jurisdictions to disclose material risks for companies with public debt or equity. The task force worked closely with developers of other climate disclosure frameworks (including the CDP) to make use of preexisting and commonly used recommended disclosures. In this way, the task force recommendations do not introduce *yet another framework* for voluntary reporting, but they will rather act as a catalyst for consistent climate-related financial disclosures. This should increase the quality and quantity of information, while reducing the burden on those preparing the reports.

## Climate risks place growing pressure on strategies and operations

In adopting the TCFD recommendations, companies will need to link those issues associated with climate change with their strategy, risk, and opportunity analysis. The information not only offers greater transparency for investors and other stakeholders but also can provide companies with insights into building greater resilience in the face of rising climate-related risks. As highlighted in the *Global Risks Report 2017*, climate change is a major trend underlying the top 10 global risks; extreme weather was among the top five global risks in terms of both likelihood and impact over the next 10 years, as was the failure of climate-change mitigation and adaptation.[10]

The TCFD report suggests climate-related risks and opportunities be grouped into the following categories (see exhibit on page 4):

- **Physical risks** relating to acute risks such as extreme weather events, and chronic risks associated with long-term shifts in climate patterns with impact on resource availability.
- **Transition risks** relating to the move to a lower-carbon economy, including policy, legal, technology, market, and reputational risks.
- **Climate-related opportunities**, including opportunities to improve resource efficiency, manage energy costs, develop new products and services, capture new markets, and improve organizational resiliency.

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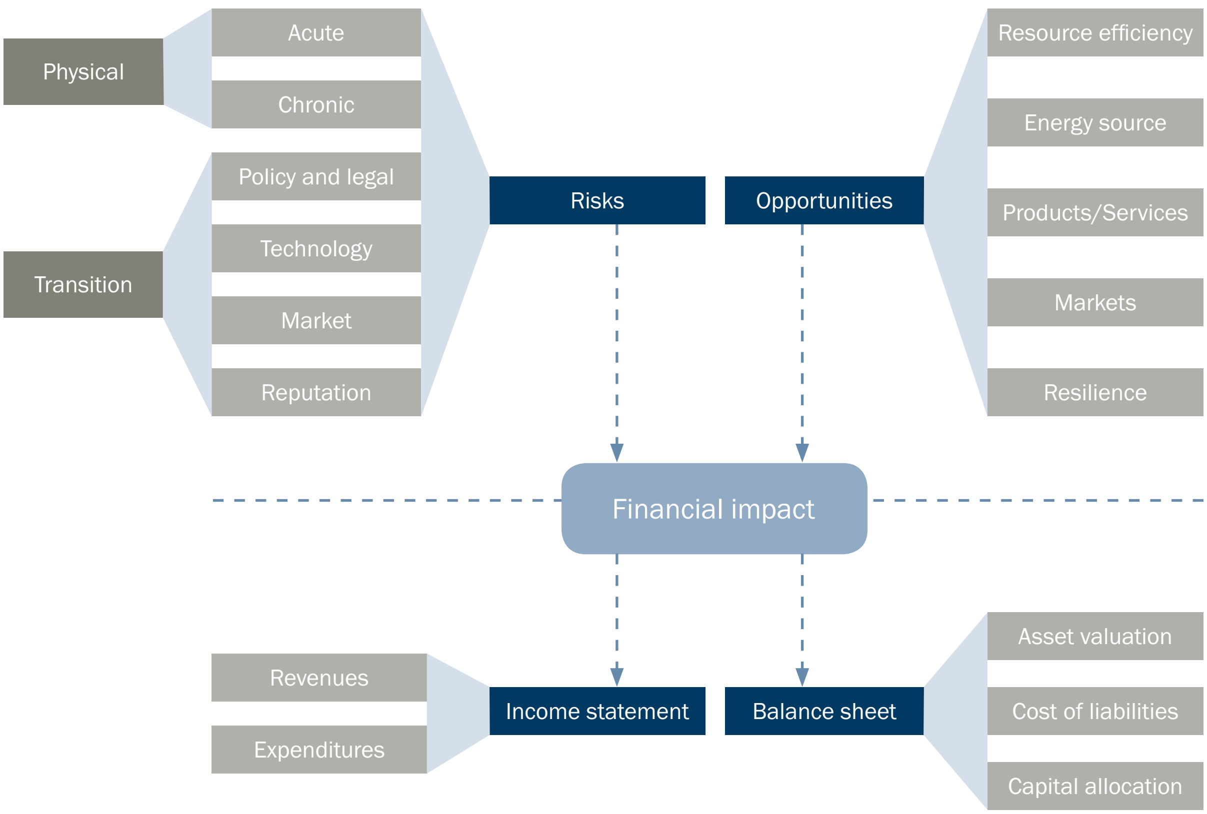
7 See also, *Unlocking Growth by Integrating Sustainability: How to Overcome the Barriers* by Lucy Nottingham, director, Global Risk Center, Marsh & McLennan Companies, 2016. http://www.mmc.com/content/dam/mmc-web/Global-Risk-Center/Files/Unlock-growth-by-integrating-sustainability.pdf

8 To learn more about the task force, draft reports and timeline of activities, please visit www.fsb-tcfd.org.

9 The task force included Marsh & McLennan Companies' Jane Ambachtsheer, partner, Mercer Investments. A list of all members can be found at www.fsb-tcfd.org.

10 *The Global Risks Report 2017*, World Economic Forum, prepared with the support of Marsh & McLennan Companies. http://www.mmc.com/global-risk-center/overview/grc-global-and-emerging-risks.html

**Climate-related risks and opportunities can impact organizations' financial performance.**




*Source:* Recommendations of the Task Force on Climate-related Financial Disclosures

Examined through this lens, it is clear that companies across all industries—including those in the financial, energy, transportation, materials and building, and agriculture and food sectors—are, or will be, affected by the physical and transitional impact of climate change. For example, beverage companies are increasingly sponsoring public-water restoration projects to hedge against drought-related risks, which could hamper production and drive up their costs. Denim and textile companies are investing in new technologies to produce fabrics without using any water, allowing them to realize cost savings and simplify their operations in an era of increasing water scarcity. Car manufactures are leveraging the "Grid of Things" to support their long-term strategies with electric cars. Household appliance manufacturers are responding to demands for greater energy efficiency in their products. Banks are reviewing credit-risk assessment and lending procedures and are incorporating climate risk into their loan-making process. Asset managers are exploring top-down and bottom-up tools and analysis to support more effective modelling and pricing of climate-related information.

### Climate change and the personal liabilities of company directors

The increasing focus on climate-change exposures presents new and different challenges for directors and their companies, with the threats of class action lawsuits, significant remediation costs, and irreversible damage to the corporate and personal brand growing ever more likely. Some of the allegations that may trigger directors and officers (D&O) policies include:

- **a.** Breaching fiduciary duties in not considering the financial risks associated with climate change
- **b.** Failing to comply with legislative reporting requirements
- **c.** Failing to disclose climate-related liabilities
- **d.** Disseminating false or misleading or incomplete information on climate risks
- **e.** Mismanagement of climate-related risks
- **f.** Negligence in allowing the company to emit greenhouse gases into the atmosphere
- **g.** Failing to protect the company's assets

To hedge against this landscape, companies must carefully consider what protection for climate-change exposure can be provided through current D&O policies. In addition, they should examine what potential gaps exist and how a policy is going to respond in the event of an environmental issue, shareholder litigation, or regulatory scrutiny.[11]

## Recommended framework for disclosure of climate-related risks and opportunities

Understanding and disclosing the financial impact of climate-change risk will require the same level of oversight and management as other aspects of risk and financial reporting to ensure information that is relevant, clear, comparable over time, verifiable, and timely. This has implications for boards of directors, senior executives, chief investment officers, chief risk officers, and risk leaders. The task force structured its recommendations around the following four thematic areas that represent core elements of how organizations operate:

- **Governance:** The organization's governance around climate-related risks and opportunities, including the role of the board. Consideration of climate impact will need to be integrated into organizations' overall processes, including strategy setting and risk management.
- **Strategy setting:** The actual and potential impact of climate-related risks and opportunities on the organization's strategic and financial planning. This may include an assessment of how various climate-change scenarios could affect operations and performance. This will require that CFOs and Chief Investment Officers familiarize themselves with the impact of climate-related risks and the use of scenario-planning tools in setting strategy.[12]
- **Risk management:** The process used by the organization to identify, assess, and manage climate-related risks. Organizations should identify these climate risks and opportunities in the short, medium, and long term.

11 *Climate Change on the Corporate Governance Landscape*, Marsh, 2016. https://www.marsh.com/content/dam/marsh/Documents/PDF/en_au/Climate%20Change%20on%20the%20Corporate%20Governance%20Landscape.pdf

12 For more, see "Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities," available at www.fsb-tcfd.org.

- **Metrics and targets:** The metrics and targets used to assess and manage relevant climate-related risks and opportunities. For example, utilizing carbon footprint and other climate-risk metrics or targets can be used to make and monitor investment decisions.

Given their potential impact on the organization, climate-related risks must be integrated into the company's ongoing risk assessment and quantification processes and the board's oversight of risk management. In describing the board's oversight of climate-related issues, the TCFD recommends that directors consider the following to support disclosure:

- Processes and frequency by which the board and/or board committees (such as audit, risk, or other committees) are informed about climate-related issues
- Whether the board and/or board committees consider climate-related issues when reviewing and guiding strategy, major plans of action, risk-management policies, annual budgets, and business plans, as well as when they are setting the organization's performance objectives, monitoring implementation and performance, and overseeing major capital expenditures, acquisitions, and divestitures
- How the board monitors and oversees progress against goals and targets for addressing climate-related issues

### Five questions directors should be asking management

Given the rising challenges of climate-related risks and the growing demands for improved disclosure, boards can use the following questions to guide board-management dialogue and to understand the organization's climate resilience:

1. Are our strategies and operations at risk, given expected climate changes and the drive to a low-carbon economy?
2. Is the organization's governance of climate-related risks and opportunities robust and effective?
3. Does the organization's strategy and financial planning accurately assess and reflect the actual and potential impacts of climate-related risks and opportunities?
4. Does the organization have a process in place to identify, assess, quantify, and manage climate-related risks?
5. Is the organization using metrics and targets to assess and manage relevant climate-related risks and opportunities?

## Conclusion

Understanding a company's impact on the climate will continue to be a key element of sustainability programs and corporate reporting. But it is critical that boards and senior management have clear insights into the financial impact of climate change on their company's strategy and operations. The draft recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures are a good starting point for climate-related disclosures by companies and will likely be accepted by the market and investors. Companies that can respond to the risks of climate change by improving their resilience are likely to emerge as industry leaders in this changing business environment.

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