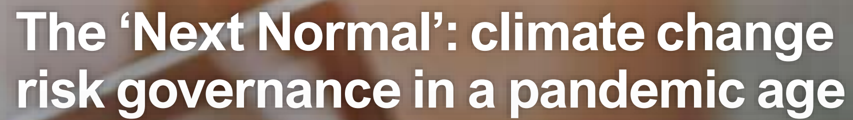

The 'Next Normal': climate change risk governance in a pandemic age

What does COVID-19 mean for climate risk assessment and disclosure in FY20?

May 2020

We create lasting impacts.

Introduction

In this report, MinterEllison's Climate Risk Governance team considers the impact of COVID-19 on corporate climate risk assessment and reporting expectations in FY20.

It provides a useful resource for sustainability, finance and executive teams in their consideration of governance priorities beyond the immediate pandemic response.

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Key takeaways

While there may be some moderation in immediate corporate progress on climate change risk management during the COVID-19 pandemic, regulatory and investor expectations are unlikely to significantly diminish in 2020.

Corporates may face increasing investor pressure to make a 'Paris Agreement-aligned' business strategy a central pillar of their corporate rebuilding and recovery plans, with a measurable pathway to net zero emissions.

The systemic economic fragilities exposed by COVID-19 illustrate the value of the key risk management tool underpinning corporate strategy on climate change – stress-testing and scenario planning – and the insights it provides in the estimation and reporting of financial position
and prospects.

Communicating credible progress on climate risk assessment and transition strategy in the narrative reports and financial statements should remain a key focus for corporates in the lead up to 30 June.

Executive summary

Remember February? Only a few short months ago, climate change was the most significant threat to the global economy. Not only a long-term issue or simply a matter of carbon policy, the bushfire crisis had brought a sense of immediacy to conversations on the impacts of climate change on Australian businesses.

We experienced first-hand the devastating impacts of a changing climate – on the environment, people, communities, and businesses, from tourism to agribusiness and transport. In capital markets, regulators and mainstream investors were growing louder in their calls for corporations to stress-test their strategies against a range of potential climate futures. Scenarios were extended to a disorderly transition to a net zero emissions economy (ie one in which as many global carbon dioxide-equivalent emissions are absorbed as are released into the atmosphere). And, for the first time, all of the top five risks to the global economy identified in the World Economic Forum's annual Global Risks Report were related to climate and the environment.

Fast-forward a matter of weeks, and the central focus of business and government has by necessity shifted to the health, social and economic crisis presented by COVID-19. Finance and governance teams' attention has been consumed by the fall out of project delays, capital raisings, mass employee stand-downs and the withdrawal of earnings or dividends guidance. But will regulatory and investor understanding of those pressures extend to tempering their expectations around climate risk strategy and disclosure in FY20 reports?

To answer that question, it is useful to remain focused on what we *do* know about regulatory and investor expectations on corporate climate risk assessment and disclosure. What we know so far indicates that climate change will remain an institutional priority in the 2020 reporting season:

1. **Narrative reports:** regulatory disclosure requirements for narrative financial report components continue to apply. As an economic 'black swan' event, COVID-19 illustrates the role of stress-testing and scenario planning as a risk management tool – itself a central plank of the recommendations of the G20 Financial Stability Board Taskforce on Climate-related Financial Disclosures (TCFD);

2. **Financial statements:** the reasonableness, and consistent application, of material climate-related financial assumptions in financial statement accounting estimates is squarely relevant to financial reporting and audit;

3. **Mainstream investors:** institutional investor expectations on corporate climate-related strategy and risk management accelerated sharply in 2019 and, having done so, are unlikely to regress significantly;

4. **Net zero strategy:** Both 'activist' investors and, increasingly, mainstream institutional investors continue to place pressure on companies exposed to the economic transition to articulate their strategy for continuing to create value in a 'net zero emissions' world; and

5. **Regulators:** Whilst central banks and financial regulators are moderating direct corporate engagement during the pandemic, their oversight of climate risk impacts and disclosures is continuing.

These themes are expanded below. While short-term levelling of corporate mitigation and adaptation ambitions may read as 'prudent austerity' in the face of immediate COVID-19 pressures, taken together, these themes suggest that reporting entities would be ill-advised to equate this with regulatory or market tolerance of wholesale contraction of effort on corporate risk management and reporting on climate-related financial risks.

1. Narrative reports

Regulatory disclosure requirements for narrative financial report components continue to apply.

Updates to ASIC's Regulatory Guides 228 and 247 in August 2019 require fundraising disclosure documents for retail investors and annual report Operating and Financial Reviews (OFRs) to contain information on the impact of climate change on financial performance, position and prospects. The updates clarify the application of ASIC's existing regulatory guidance to the disclosure of climate change related risks and opportunities by:

- Incorporating the types of climate change risk described in the TCFD recommendations into the list of examples of common risks that may need to be disclosed in a prospectus;
- Highlighting climate change as a systemic risk that could impact an entity's financial prospects for future years and that may need to be disclosed in an OFR; and
- Directing reporting entities to ensure that disclosures made outside the OFR (such as under the voluntary TCFD framework or in a sustainability report) are not inconsistent with disclosures made in the OFR.

The updates to RG 247 also make clear ASIC's general view that the risk of directors being found liable for a misleading or deceptive forward-looking statement in an OFR is minimal, provided: the statements are based on the best available evidence at the time, have a reasonable basis, and there is ongoing compliance with the continuous disclosure obligations when events overtake the relevant statement made in the OFR.

It would be both premature and simplistic to wholly equate COVID-19-related exposures to climate-related financial risks. However, it may be that COVID-19 operates to increase pressure on reporting entities to prioritise stress-testing and scenario planning in accordance with the TCFD recommendations. As former Governor of the Bank of England, Mark Carney, wrote in The Economist:

[T]he searing experience of simultaneous health and economic crises will change how companies balance risk and resilience. We are entering a world in which firms will be expected to prepare for black swans by valuing anti-fragility…and planning for catastrophe…. [1]

[1] Mark Carney, 'The world after covid19: how the economy must yield to human values', *The Economist*, 16 April 2020, <here>

2. Financial statements

The reasonableness, and consistent application, of material climate change-related assumptions in accounting estimates is squarely relevant to financial reporting and audit.

In April 2019, the Australian Accounting Standards Board and Auditing and Assurance Standards Board issued joint guidance stating that climate change-related assumptions have the potential to be a material accounting estimation variable, impacting on asset useful lives, fair valuation, impairments and provisions for bad and doubtful debts. Although the guidance is 'voluntary', the standard setters made clear that they 'expect' it will be applied by report preparers and auditors. In response, a number of large accounting practices report that they have implemented climate risk training programs for audit and assurance teams. ASIC followed with its own guidance in August 2019, updating *INFO 203: Impairment of non-financial assets: Materials for directors* to highlight climate change and other risks that may be relevant in determining key assumptions that underly impairment calculations.

The form and detail of disclosures made pursuant to the joint guidance may vary significantly as reporting entities and their auditors grapple with the new directive. However, its potential application was starkly illustrated in December 2019, when European oil and gas major Repsol announced that as a result of its rebasing of demand assumptions to be in line with Paris Agreement targets, it was writing down the reported value of its reserve assets by €4.8 billion.

Overall, there is increasing potential for climate-related financial assumptions to become subject of material audit issues in the external audit report. Corporate report preparers and board Audit & Risk Committees should understand their internal approach on relevant variables and assumptions, and be prepared for engagement from the external auditors on point.

3. Mainstream investors

Expectations on corporate climate-related strategy and risk management accelerated sharply in 2019.

2019 signalled a shift in mainstream investor expectations on TCFD-aligned disclosures, moving from 'gold standard' to 'base expectation' in exposed industries. By January 2020, institutional investors with US$40 trillion under management had joined the Climate Action 100+, collectively engaging with large investee emitters to strengthen climate risk governance and disclosure by reference to the TCFD. With potential changes to capital regulatory requirements flagged under the EU's Green New Deal, debt funders began to explicitly price climate-related default risk exposures via 'sustainability linked loans', with annual margin adjustments linked to the borrower's performance against negotiated corporate sustainability targets.

Large institutional investment groups – from BNP Paribas to Nuveen, DWS, Allianz, Comgest and the world's largest asset manager, BlackRock - have warned investee companies not to backtrack on their climate commitments despite the COVID-19 curve-ball, seeing them as important indicators of downside risk mitigation, corporate resilience and long-term value creation. Michelle Edkins, global head of BlackRock's investment stewardship team, is quoted in the Financial Times as emphasising:

'We are looking at these [issues] long term. These are not new issues…Companies can still demonstrate that they have effective leadership. In times of crisis that becomes more apparent, not less apparent.' [2]

Whilst the trajectory of acceleration in expectation may level in 2020 with immediate COVID-19 concerns, it is showing no signs of 'loosening' or 'back tracking'.

[2] Mooney, A., 'BlackRock to target companies on governance despite coronavirus', *The Financial Times*, 18 March 2020. See also Mooney, A., 'Big investors warn companies against backtrack on climate change', *The Financial Times*, 19 April 2020.

4. Net zero strategy

Both 'activist' investors and, increasingly, mainstream institutional investors continue to place pressure on companies exposed to the economic transition to articulate their strategy for value creation in a 'net zero emissions' world.

Corporate resilience to a 'disorderly' transition to a low-emissions economy, characterised by non-linear shocks, continues to be a focus of shareholder resolutions. Asset management giant Nuveen notes in its 2020 Proxy Preview (April 2020):

Stakeholders expect corporations to showcase measurable carbon reduction goals with specified time horizons, science-based rationales for chosen key performance indicators and explanations for how sustainability efforts tie into broader business goals. So far in 2020…66% of the environmental proposals request action rather than just disclosure. Shareholders expect companies to align with the Paris Agreement on climate change and are requesting scenario analyses that assess physical and transition risk.' [2]

Mainstream investors are increasingly voting in favour of activist shareholder resolutions seeking corporate disclosure of net zero emissions strategies – even where such resolutions are not supported by management. For example, the April AGMs of listed oil and gas companies Santos and Woodside Petroleum were subject to shareholder resolutions on climate change and industry lobbying. Activist ethical investor organisation the Australian Centre for Corporate Responsibility arranged both sets of resolutions, requesting that the companies report Paris-aligned emissions reductions targets across all scopes of emission (including scope 3 emissions from the end-use of their products), their alignment of capital expenditure with those targets, and the linkage of executive incentives, and secondly that they suspend membership of industry associations whose advocacy runs counter to the goals of the Paris Agreement. Despite management recommendations to vote against the proposals, shareholder support registered at 43% / 46% at Santos, and 50.16% / 42% at Woodside Petroleum – figures no doubt influenced by support from large proxy advisors ISS and Glass Lewis. Similar resolutions have been filed for a number of upcoming AGMs in the financial services and resources sectors not only in Australia, but in the United States, UK and Europe.

COVID-19 has also done little to dampen the corporate trend towards embracing commitments to transition to net zero emissions by (or before) 2050. This includes a notable announcement by Shell in April, which itself followed a lead taken by BP in February. Whilst the scope of such pledges (including direct vs indirect scopes, the use of voluntary offsets etc) continues to be subject of debate, it illustrates the compounding pressure on business to realign their strategies to be resilient to Paris Agreement targets.

This trend is not limited to the energy and resources sector. For example. in late April, Japanese pharmaceutical giant Takeda announced that its 1.5°C climate action strategy had been endorsed by the Science Based Targets Initiative. Takeda's targets include the halving of scope 1 and 2 emissions by 2025 (from a 2016 baseline), and achieving carbon neutrality by 2040. To tackle scope 3 supply chain emissions, it pledged to ensure that more than two-thirds of emissions from its goods, services, transport, and distribution suppliers are subject to their own science-based emissions targets by 2024. Even Takeda's ambitious commitments pale in comparison to that made by tech giant Microsoft earlier this year. In January, CEO Satya Nadella announced its ambition to achieve carbon neutrality by 2030. He went further to commit Microsoft to operating on a *carbon negative* basis from 2030 – removing more carbon from the atmosphere than it emits - with a goal of removing emissions greater than those that are attributable to its operations since its founding in 1975, by 2050.

5. Regulators

Whilst central banks and corporate regulatory authorities are moderating expectations on direct corporate engagement for the balance of FY20, their climate-related supervision and oversight programs are continuing in the background.

In late March, the Bank of England Prudential Regulation Authority announced that it would defer consideration of its landmark consultations on climate change stress testing until the English summer. Here in Australia, APRA made a similar announcement that it would suspend its planned 2020 agenda of policy and supervision initiatives (which included consultation on climate-related stress testing and related prudential guidance) until at least 30 September 2020. However, business would be ill-advised to take these announcements as a signal that these issues are no longer priorities for the regulators. Whilst APRA, ASIC and ASX have all issued specific guidance on regulatory relief during the COVID-19 pandemic, this has very much been focused on earnings guidance, capital raising and AGM logistics, rather than signalling a relaxation of the disclosure standards designed to maintain market integrity. ASIC and APRA have indicated that their own internal climate risk assessment and report monitoring program continues to operate, even as they recognise the need to moderate direct engagement with regulated entities in the immediate term.

On 20 April, ASIC specifically addressed its on-going supervisory program on climate change in Report 659:

Climate change disclosure surveillances

We are currently undertaking further surveillance work examining public climate change-related disclosure by a number of ASX 100 companies over the last reporting period. We are focused on companies that are reporting under the recommendations developed by the Financial Stability Board's Taskforce on Climate-Related Financial Disclosure. Our surveillance program includes both desktop research and the use of compulsory information-gathering powers. We intend to publish our observations once the surveillance is complete and provide direct feedback to the entities involved. This work will help ASIC determine whether further guidance in this area is necessary.

Separately, we continue to liaise with the Australian Prudential Regulation Authority (APRA), the Reserve Bank of Australia (RBA) and Treasury on this issue. We are all part of the Council of Financial Regulators' Climate Change Working Group. APRA is planning to conduct a climate change financial risk vulnerability assessment of Australia's largest authorised deposit taking institutions. APRA's vulnerability assessment will be designed in 2020 and executed in 2021. APRA will coordinate the design of its vulnerability assessment with both ASIC and the RBA, to ensure consistency in the application of scenario analysis and disclosure recommendations.

Accordingly, whilst regulatory enforcement of climate disclosure requirements may seem a distant prospect, it is clear that regulatory capacity quietly continues to develop.

Conclusion

Whilst market stakeholders may understand immediate pressures involved in tackling the COVID-19 pandemic, there remains a strong investor focus on corporate commitments to longer-term net zero emissions strategies. Accordingly, reporting entities would be ill-advised to assume that they will get a wholesale 'leave pass' for this year's reports – particularly in exposed industries such as mining, energy, transport, construction materials, agriculture and real estate.

Investors are likely to continue to demand evidence of progress on the climate risk governance and reporting journey, albeit with potentially tempered expectations around the short-term trajectory of ambitions in the context of immediate COVID-19 challenges. Corporations would be well-advised to continue to consider a credible pathway to continued value creation in the transition to a net zero emissions economy.

Next steps?
Top five questions for corporate governors to consider

The following five questions will assist in your consideration of whether your 2020 climate risk governance and disclosure activities remain robust as we move closer to 30 June:

1. **TCFD:** Have we made credible inroads on the journey towards compliance with the Recommendations of the Taskforce on Climate-related Financial Disclosures in FY20? Have we fulfilled intentions and specific steps previously signalled to the market?
2. **Net zero:** Have we committed to an emissions reduction trajectory that is consistent with Paris Agreement targets? Have we progressed with plans to achieve that commitment, and integrated these plans into our prevailing business strategy and risk management frameworks?
3. **Corporate resilience:** If progress on climate risk has been deferred or de-prioritised due to immediate COVID-19 management issues, do we have a timeline for recommencement? Do we remain committed to implementing our short, medium- and long-term climate risk strategies and to achieving our targets?
4. **Narrative disclosures:** How will we accurately reflect our position on climate risk governance, strategy and risk management in our 2020 Operating and Financial Review?
5. **Financial statements:** What consideration has been given to the climate-related variables that may materially impact on our accounting estimates (financial position) and prospects? What range of assumptions are reasonable, and what is our central case? Have we undertaken scenario analysis against a range of stressed scenarios – including a disorderly transition to a net zero economy? How have these variables been integrated into our accounting estimates, project feasibility models and financial statements disclosures?

How Minter Ellison's Climate Risk Governance team can help

Minter Ellison's Climate Risk Governance team is an integral part of our Responsible Business practice. We lead the market in advising on climate change through a corporate law lens.

Our unique multi-disciplinary team of lawyers and auditors works closely with scientists, economists, financiers and international regulators to ensure that our clients have the benefit of global thought leadership in this dynamic risk area. Our subject matter expertise is combined with deep sectoral experience to provide an unrivalled commercial lens across climate-related risk, governance and disclosure law issues.

We would be pleased to share our expertise with you in the 2020 reporting season, including:

- Capacity-building on climate-related financial risks boards, finance and governance teams
- Board oversight: due care and diligence assurance and advisory
- Transition strategy, governance and risk management advisory
- Annual reports: disclosure assurance and advisory – alignment with TCFD and updated ASIC RG247, benchmarking to peer- and global-best practice
- Investor relations, AGM and executive remuneration advisory
- Climate risk litigation advisory and defence
- Project, transactional and finance due diligence - specialist modules on climate-related risk issues
- Material contract reviews – advice on identification, risk allocation and efficiently pricing of climate risk exposures

Part II in our series on climate risk governance in a pandemic age will be released in the coming months: *The 'Next Normal' – What next for climate risk governance and investment in a post-CV19 world?*

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We create lasting impacts.

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