Recent Developments in Climate Risk Governance

What to Watch in 2020

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MinterEllison

2020's 'new normal': climate change risk review and governance issues to watch in the year ahead

Our Climate Risk Governance team outlines developments in climate change risk across five key areas - climate risk disclosure and reporting, directors' duties, equity markets, debt finance and emissions reductions policies - and flags developments to watch in 2020.

The bushfire crisis has brought a sense of immediacy to conversations on the impacts of climate change on Australian businesses. What many viewed as only a long-term issue, or simply a matter of carbon policy, this summer has seen Australian communities and businesses experience first-hand the impacts of a changing climate. The impacts on people, communities and the environment are devastating. There is also an economic cost: ASX-listed insurers have issued revised earnings guidance; agribusinesses are reporting massive livestock losses; the tourism industry has seen the 'worst summer on record'; transport interruptions are causing disruption to many industries; and the wine industry is dealing with the impacts of smoke taint on vineyards. As these first, second and third-order impacts of the bushfires compound across the economy, Goldman Sachs has estimated the impacts could reduce Australia's GDP by 0.4%, with significant longer term tail risks.[1]

While for some, this summer has been a turning point in understanding the financial impacts of climate change, leading market stakeholders have recognised that climate change poses financial risks to Australian businesses and the broader economy for some years now. With the building momentum towards zero emissions, climate change is a dominant trend creating risks and opportunities for businesses across all sectors of the economy and over mainstream investment horizons. For the first time, all of the top five risks in the World Economic Forum's annual Global Risks Report released this month are climate and environmental risks.[2]

Our team outlines the most significant developments in climate risk governance over the past year, and looks ahead to what is in store for 2020 and beyond. Not only do we see these trends continuing, but the focus on climate risk will increase significantly with two key factors at play. Domestically, the profound devastation and destruction caused by the bushfires will keep climate change in the collective Australian consciousness and put renewed pressure on governments and businesses to act. Internationally, in the lead up to the COP26 in Glasgow in December 2020, the most important international climate change conference for five years, international governments with ambitious climate policies will put pressure on perceived laggard countries with trade levers on the horizon that may directly affect Australian businesses.

[1] Simon Evans, Sue Mitchell, James Fernyhough and Jenny Wiggins, 'Bushfire fallout a big risk for investors', Australian Financial Review (25 January 2020).
[2] https://www.weforum.org/reports/the-global-risks-report-2020

Key recent developments

1. Climate risk disclosure & reporting – regulatory & investor expectations continue to rise

Key recent developments

In 2019, Australian regulators' and standard setters' expectations on climate risk reporting moved beyond narrative disclosures to the financial statements

- The 2017 Recommendations of the Bloomberg Taskforce on Climate-related Financial Disclosures (TCFD) moved from gold standard to base expectation, with an increasing number of corporations, asset managers and asset owners applying the governance, strategy, risk metrics and disclosure framework to the management and disclosure of climate risks and opportunities, or signing up to do so in future reporting cycles.
- In August 2019, the Australian Securities and Investment Commission (ASIC) revised its regulatory guidance on market disclosures to identify climate-related financial risks. These include those described by the TCFD recommendations as key risks that may need to be disclosed in prospectuses (RG228) and annual report Operating & Financial Reviews (RG247).
- In April 2019, the Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AUASB) updated their joint bulletin on climate risk disclosures required by accounting standards – guidance that has since been echoed by the International Accounting Standards Board (IASB).[3]

Over the horizon: what to watch in 2020 and beyond

In 2020, there is likely to be a noticeable shift from intention to implementation by companies, and an uptick in supervisory and enforcement action by regulators

- Alignment with TCFD recommendations will solidify as a 'mainstream' disclosure expectation.
- Companies will look to apply the AASB/AUASB joint bulletin on climate risk assumptions in accounting estimates and financial statements, and face external audit scrutiny on point.
- ASIC will conduct regulatory investigations into the adequacy of climate risk disclosures in annual reports, although we may not see the first enforcement action for a further year.
- Following first movers the Bank of England and the Banque de France, on 30 January APRA announced that it will move to conduct climate stress tests on large Australian insurers, banks and superannuation funds to test their resilience to the physical and transition risks associated with different possible climate scenarios. Consultation on the stress-tests will commence in 2020, with application in 2021.

[3] Nick Anderson, IFRS Standards and climate-related disclosure, IFRS Foundation (28 November 2019) <https://www.ifrs.org/news-and-events/2019/11/nick-anderson-ifrs-standards-and-climate-related-disclosures/>.

2. Directors' duties - heightened expectations on boards' climate-risk strategy and oversight

Key recent developments

In 2019, the standard of care required to fulfil directors' existing legal duties to consider and disclose climate risk was elevated

- In March 2019, Hutley SC updated the seminal legal opinion on directors' duties and climate change, concluding that there has been a demonstrable shift since 2016 in the way in which Australian regulators, firms and the public perceive climate risk which 'elevate the standard of care that will be expected of a reasonable director'.[4]
- In November 2019, former Australian High Court judge and financial services royal commissioner Kenneth Hayne made a significant public intervention, stating that the law and science are clear: 'a director acting in the best interests of the company must take account of, and the board must report publicly on, climate-related risks and issues relevant to the entity'.[5]
- 'Climate litigation' against companies and their directors accelerated internationally, with dozens of cases filed across the US and EU by regulators, bondholders, shareholders and municipalities. Causes of action ranged from tort and consumer law to breach of duty and securities fraud. In Australia, litigation continued against the corporate trustee of $50 billion FUM superannuation fund REST, with a member alleging (amongst other claims) that the trustee's failure to integrate climate change considerations into its investment strategy breached the trustee's duty of due care, skill and diligence.

Over the horizon: what to watch in 2020 and beyond

In 2020, minimum standards of climate risk governance will continue to elevate

- ASIC may seek to enforce regulatory guidance by commencing regulatory investigations into the adequacy of climate risk governance by Australian boards, although any enforcement action for breach of directors' duties will likely be intertwined with, or follow, an action against the company for breach of mandatory disclosure obligations.
- In the face of increasing pressure from investors and regulators, directors will increasingly seek to develop their capacity on climate change, utilising subject-matter specialists as appropriate.

[4] Noel Hutley SC and Sebastian Hartford-Davis, Climate change and directors' duties: Supplementary memorandum of opinion (March 2019) <https://cpd.org.au/2019/03/directors-duties-2019/>. MinterEllison was the instructing solicitor on the 2016 and 2019 briefs.

[5] Kenneth Hayne, 'What Kenneth Hayne says about climate change' (9 December 2019) <https://www.afr.com/politics/federal/what-kenneth-hayne-says-about-climate-change-20191206-p53hiw>; James Fernyhough, Hayne rebukes directors on climate risk failure (9 December 2019) <https://www.afr.com/policy/energy-and-climate/hayne-rebukes-directors-on-climate-risk-failure-20191206-p53hnd>; Ben Hayne, 'No more room for excuses on climate' (9 December 2019) < https://www.afr.com/politics/federal/no-more-room-for-excuses-on-climate-20191208-p53hwk>. Full text of Kenneth Hayne AC QC remarks to CPD climate roundtable (9 December 2019) Speech delivered to Centre for Policy Development Roundtable in Sydney, 21 November 2019 <https://cpd.org.au/2019/12/full-text-of-kenneth-hayne-ac-qc-remarks-to-cpd-climate-roundtable/>.

3. Equity markets – divestment, engagement and mainstream shareholder activism

Key recent developments

2019 saw 'mainstream' institutional investors join in collective engagement and shareholder activism on climate-related financial risks, and continued growth in stock divestment on financial risk/return grounds

- At the UN climate action summit in September 2019, a group of institutional investors representing more than US$4 trillion in AUM launched the Net-Zero Asset Owner Alliance, committing to transition their portfolios to net-zero greenhouse gas emissions by 2050.
- In January 2020, BlackRock, the world's largest fund manager with over US$7 trillion in AUM, joined the Climate Action 100+, set out its expectation that companies disclose in accordance with the TCFD recommendations and the Sustainability Accounting Standards Board (SASB) framework, and announced it will divest its active funds from companies that derive more that 25% of revenues from thermal coal production. The Climate Action 100+, a global investor coalition to drive corporate action on climate change, now represents investors with US$40 trillion in AUM.
- The European Union continued to progress key components of its Sustainable Finance Action Plan, reaching agreement on the text of a proposed 'taxonomy' (a green finance dictionary). It also developed new disclosure requirements to require asset managers who sell financial products in Europe to disclose the 'sustainability risks' and 'sustainability impacts' of their investments.

Over the horizon: what to watch in 2020 and beyond

Investor 'asks' in 2020 are likely to increase in number and sophistication

- Climate-related shareholder resolutions for Australian companies continue to increase in quantity and proxy support. We may see the first votes against director appointments or remuneration by institutional investors related to concerns on climate risk management and strategies to transition to net zero.
- 'ESG' investing is likely to face greater scrutiny as it moves into the mainstream. The social impact end of the responsible investment spectrum will mature as the European funds industry begins to grapple with the disclosure of 'sustainability impacts'.
- The $US80 trillion+ signatories to the UN Principles of Responsible Investment (PRI) are likely to begin to price in the likelihood of an abrupt and disorderly transition as forecast by the PRI's Inevitable Policy Response. They are also likely to question investee companies on the resilience of their strategy to such a disruptive transition.[6]

[6] https://www.unpri.org/inevitable-policy-response/what-is-the-inevitable-policy-response/4787.article.

4. Debt markets – capital regulation, credit ratings and sustainability-linked margin structures

Key recent developments

Banks, bondholders, and credit ratings agencies began to price the risks and opportunities of climate change and sustainability

- In March 2019, the Reserve Bank of Australia added its voice to the climate conversation, with Deputy Governor Dr Guy Debelle setting out how it incorporates climate risk into its macroeconomic modelling and monetary policy. This was followed by an extended analysis of climate-related impacts in its October 2019 Financial Stability Review.
- Approximately 50 central banks, including the RBA, joined the Network for Greening the Financial System (NGFS), issuing a call to incorporate climate risk into prudential regulation and supervision activities, encourage climate-related financial disclosures, and incorporate climate risk into their own balance sheets.
- In October, the International Monetary Fund (IMF) announced it will incorporate climate risk into its country risk assessments. Its January 2020 update to the World Economic Outlook nominated climate change as a key handbrake on global economic growth.
- In November, the Swedish Central Bank announced that it had divested from sovereign bonds issued by WA, Queensland and Alberta (Canada) due to their 'climate footprints'. [7]
- The market for sustainability-linked loans exploded from a standing start in 2018 to more than US$120 billion by the end of 2019, as banks attempted to formalise climate risk pricing algorithms, and grappled with potential changes to capital regulatory requirements to embed a 'green discount (supporting factor) or brown penalty (panelising factor)' (including in the EU and China). Companies from industries as diverse as insurance, agriculture and real estate took advantage of proactive climate risk management plans to lower their cost of capital.
- The fourth edition of the Equator Principles were released, requiring banks to specifically consider the climate-related impacts of a project in project finance due diligence using the climate risk categories outlined in the TCFD and the expected annual emissions of the project. Whilst not applicable to mandated transactions until 1 July 2020, financial institutions may apply the revised principles voluntarily in advance.

Over the horizon: what to watch in 2020 and beyond

Banks and central banks recognise their role in making financial flows consistent with a zero-carbon economy as agreed under the Paris Agreement

- Credit ratings agencies are likely to further integrate climate risk considerations into mainstream sovereign, sub-sovereign, corporate and facility ratings assessments.
- Central banks and supervisors will continue to push the financial sector to manage climate risk as part of their financial stability mandates, with further progress on prudential regulation (a 'green supporting factor' or 'brown penalising factor' in capital requirements) or increased green collateral for central banks.
- Following the lead of the Swedish Central Bank on Alberta, WA and Queensland sovereign bonds, additional central banks and European sovereign wealth funds are likely to limit their exposures to municipal and sub-national bonds issued by jurisdictions judged to be particularly vulnerable to climate risk or lacking adequate climate mitigation/ adaptation policies.
- Financial institutions will conduct more robust climate risk analysis, with projects and companies in high impact sectors to face tougher financing conditions, while those in transition or low-carbon industries find increasing opportunities to reduce their cost of capital.

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[7] https://www.afr.com/world/europe/sweden-sells-off-canada-australia-bonds-over-climate-change-20191114-p53akq

5. Emissions reduction policy – corporate offsets and trade pressures increase in importance

Key recent developments

The gap between Australia's federal emissions reduction commitments and those of our trading partners and peers has become increasingly stark

- In 2019, New Zealand and the United Kingdom enshrined into law net zero targets by 2050, while Finland has the ambitious aim for carbon neutrality in 2035.
- At the recent December UN climate summit in Madrid (COP25), Australia drew criticism for its plan to use 'carryover credits' from the predecessor Kyoto Protocol to meets its emissions reductions commitments under the Paris Agreement.
- The EU signalled its intention to impose border carbon adjustments on imports from countries which do not have ambitious carbon pricing policies.
- The National Carbon Offset Program was rebranded as Climate Active in Australia. There was a surge of interest in voluntary carbon offsets as corporates purchased offsets to meet increasingly ambitious emissions reductions targets.

Over the horizon: what to watch in 2020 and beyond

Foreign government trade policies will create carbon pricing pressures, overtaking domestic emissions reduction policies as key drivers of transition risk

- Many countries are expected to announce more ambitious climate policies in the lead up to COP26 in Glasgow, with increasing regulatory and policy responses.
- Australian exporters will increasingly have to price in the potential for border carbon adjustments from the EU or other jurisdictions.
- As more companies align their businesses with the goals of the Paris Agreement, the market for carbon offsets may be pushed to new highs in the short to medium term, as an interim step in the transition to net-zero emissions. If rules for a global carbon market can be agreed at COP26, this will further drive an investment uptick.
- The market for carbon offsets with verifiable co-benefits will increase in response to regulatory incentive programs (such as the Queensland government's $500m Land Restoration Fund) and consumer preferences in markets for voluntary carbon offsets which deliver a broader suite of environmental and social outcomes.

Suggested next steps

We suggest that you should initially consider the following for your organisation:

- Have your Board and Executive team developed 'climate competency'? Do they understand the heightened regulatory and investor expectations around climate risk assessment and disclosure?
- Are your annual reports aligned with the TCFD, updated ASIC RG247, and guidance from the accounting and auditing standards setters?
- Do your project, transactional and finance due diligence processes include a specialist module on climate-related risk issues?
- Have your material contracts been reviewed for climate risk exposures, and your standard processes and terms updated to ensure climate risks are identified, allocated and efficiently priced?

Please contact a member of the MinterEllison Climate Risk Governance team if you would like to discuss in the context of your organisation or if you need assistance with your climate risk management strategy in 2020.

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MinterEllison's Climate Risk Governance team is an integral part of our Responsible Business practice and leads the market in advising on climate change through a commercial law lens. The unique multi-disciplinary team of lawyers and auditors works closely with scientists, economists, financiers and international regulators to ensure that clients have the benefit of global thought leadership in this dynamic risk area. MinterEllison's subject matter expertise is combined with deep sectoral experience to provide an unrivalled commercial lens across climate-related risk, governance and disclosure law issues.