Climate Change – Not My Problem?

Company secretaries have a key role in addressing climate risk, argues Maya de Souza, Senior Manager – Policy Research, Business Environment Council Ltd, not only to ensure effective risk management and ESG reporting, but also to future proof the organisations they work for.

INTRODUCTION TO CLIMATE CHANGE ARTICLES CGQ SUMMER/FALL 2018

This article is the first of two – the second one will appear in the next issue of CGQ – that deals with the subject of climate change and its ramifications. During our discussions about the articles for this issue of CGQ, it became apparent that, although the topic has been a major concern for many companies for the last few years, recent political developments in North America may have moved the goalposts significantly for some companies. President Trump's withdrawal from the Paris Agreement, Ontario's and other Provinces' new governments and the rise of politicians who can harness the populist approach, all have their effect on the issues in these articles. And it seems we are far more likely to see the "Not My Problem" approach from our governments in the next few years.

These articles were written in advance of this trend becoming evident, but we feel they are still very relevant, emphasising the Secretary's role to convince their Boards that, despite what politicians say, climate change really may be something a well-run company must deal with.

By Nigel Blumenthal FCIS, P.Adm.

Our societies face a series of profound environmental and social challenges, said Mark Carney, Governor of the Bank of England, in a speech to the UK Insurance Industry in September 2015. The combination of the weight of scientific evidence and the dynamics of the financial system suggest that, in the fullness of time, climate change will threaten financial resilience and longer-term prosperity. With better information as a foundation, we can build a virtuous circle of better understanding of tomorrows risks, better pricing for investors, better decisions by policymakers, and a smoother transition to a lower-carbon economy. By managing what gets measured, we can break the tragedy of the horizon.

Climate change may appear as a problem for the next generation, something best dealt with by educating our children and grandchildren. It may seem at once too big to ignore, but also too overwhelming to tackle. To others it may seem like an issue for larger companies or for larger countries, not for us. For company secretaries and accountants, the question that arises is – what is your role? Are you responsible in some way?

Won't the government or the market deal with this?

There are two problems that hamper swift action, articulated so well by Mark Carney in the speech quoted above. To begin with, the tragedy of the horizon is about the enormity of the consequences of working without longer-term time horizons in mind. Essentially, if we wait until climate change in a severe form is upon us, it will be too late to act. The time lag in terms of the impact of reducing emissions is too great. However, governments, businesses and people often don't think in terms of such horizons.

The other risk is the tragedy of the commons. This is another worrying outcome – again of huge proportions – if no one takes action on the basis that this is not their responsibility, in the hope that others do instead.

What about the Paris Agreement – does this solve the problem?

The Paris Agreement 2015 is in effect, a global compact to confront this situation and avert the tragedies referred to above. It is a game-changer and you've no doubt heard it mentioned many times. What does it actually mean? It is an agreement by 197 countries to reduce greenhouse gas emissions so that the global temperature rise is no more than 2°C (two degrees Celsius) over pre-industrial levels, but agreeing to endeavour to keep this rise below 1.5°C. To achieve this, it is agreed that the world economy needs to be net zero in the second half of the century. That means that in the second half of the century, carbon emissions produced need to be absorbed by trees or captured by carbon capture and storage.

To achieve this, all countries have set their nationally determined contributions but these will need to be ratcheted up and reviewed every five years. The first stocktake is in 2018 – to be kicked off shortly when countries reconvene in

Bonn for the second follow up to the Paris Agreement referred to as COP 23 – and the first review in 2023. As part of the Paris Agreement, China has set its nationally determined contribution of 60%-65% carbon intensity reduction by 2030 and peaking emissions before then. The chances are that these targets will be made stricter before long.

Hong Kong has accordingly set its contributions in line with China's commitments – 65%-70% reduction in emissions intensity or 26%-30% reduction in absolute emissions by 2030. This is a good start in the pathway to net zero emissions. However, it does mean that the final 70% reduction will be in the 20 or so years that follow – unless Hong Kong finds some way to offset its emissions, not easy with our limited land space.

Country targets are just that. In reality, the Paris Agreement will only work if all those who are directly responsible for the emissions or who have control over them take steps to reduce their emissions for the short and medium term but also for the longer term. Investment decisions taken now by companies may have an impact on longer-term emissions, so action in the short term as well as the longer term is critical.

Why is this relevant for company secretaries?

One of the roles of a company secretary is to assist the board to understand the issues and risks in order for the board to keep them under review and make related decisions. Another is to advise the board on good corporate governance practice. There are a number of emerging risks for businesses from climate change, making consideration of climate risk a high priority. The board can contribute to the management of these risks including consideration of potential business opportunities. Recent years have also seen developments in good corporate governance – particularly regarding the need for better risk management and transparency. These are discussed in more detail below.

Risk management

Readers will no doubt be familiar with Hong Kong's Corporate Governance Code, which was revised in January 2016. Section 14, Appendix Q, states that where an issuer includes the boards statement that it has conducted a review of its risk management systems and internal control systems, it must disclose:

- how often the risk management and internal control systems are reviewed, and if a review has not been conducted during the year, an explanation of why not, and
- a statement as to the effectiveness of the procedures conducted.

There are a number of risks from climate change which need to be taken on board to be able to make an evaluation of effectiveness. Company secretaries need to understand this in order to ensure that such a statement is made in good faith. These are classified in different ways in different papers, but below we use the terminology of the G20 Financial Stability Boards Taskforce on Climate-Related Financial Disclosures (TCFD).

Physical risks. The first set of risks is about the physical impacts of climate change from rising sea levels, extreme weather, water scarcity and temperature. Some international examples of what risk assessments have found include that of a major tea company. The company found that with a 2ºC temperature rise, their tea producers in Kenya may no longer be able to supply the tea they use, so they needed to carry out research and development or look for other sources of supply. Slow action could lead to expensive supplies or no supplies. A well-known clothing company concluded that their primary raw material, cotton, would be affected by water scarcity. A local example would include the risk to Hong Kong developers from flooding and storm surges. This may lead to a diminished value of their assets.

Transitional risks. The TCFD categorises this set of risks as: policy and legal risks; technology risk; market risk and reputation risk. Two of these categories are discussed below.

Policy and legal risks. These risks relate to the impact of new climate change public policies to effect the transition to a low carbon economy, which may range from carbon pricing to regulation. Failing to factor in the impacts of such policies could prove costly. For example, with a carbon price being introduced on domestic air and rail travel, airlines that do not seek to reduce their carbon emissions may have their profitability reduced. Investing in fossil fuels extraction carries a risk of stranded assets.

Reputational risk. This risk relates to reputation – this may be consumer pressure or investor pressure. At present, we are witnessing a shift in investor behaviour beginning with institutional investors. Some are setting exclusions as to investment. Others are looking to invest in environment, social and governance (ESG) funds, and in green bonds. Discussions are beginning on how government can incentivise the flow of money to greener investments and in the end this may mean subsidies or tax breaks. So in terms of raising funds, ensuring new projects and the company as a whole are sufficiently green is likely to help.

We'd like to stress the importance of a systematic approach that takes on board all these risks. To fulfil your duty, you will need to understand these risks and check on the robustness of risk management procedures. In the next section we explore how to do so.

Transparency

Company secretaries need to take on board Hong Kong's ESG Reporting Guide (Appendix 27 of the listing rules) with its list of comply-and-explain considerations. Having regard to the four principles of materiality, balance, quantitative KPIs and consistency, a company needs to decide whether to comply and report on each of the listed items, or explain why not.

- Aspect A1 covers greenhouse gas emissions (as well as other major air pollutants) data but also policies as well as compliance with laws and regulations.
- A2 is on the efficient use of resources including energy – this specifically includes both direct and/or indirect use of energy (such as in your supply chain), as well as initiatives on energy usage.
- A3 is on the impact on the environment, which would include climate change.

The specific reference to greenhouse gas emissions in the Guide and the reference to energy usage, suggest that this aspect of environmental performance is regarded as a high priority. A company will need to take care to avoid categorising greenhouse gas emissions (of which energy usage will in Hong Kong often be the major source) as non-material without a good basis for this.

Aspect B5 is on managing supply chain impacts, and here again climate impacts are relevant. For example, companies need to consider the source of construction materials, which are often highly carbon intensive, or how materials are transported to the company.

In conclusion, neither sustainability reporting nor risk management are new. Many companies will have completed questionnaires for the CDP (formerly the Carbon Disclosure Project) and reported on carbon emissions (often simply levels of energy usage), and recognise the importance of this transparency for investor relations and consumer reputation.

All companies will have some form of risk management in place. But it is this inter-relationship of these duties that needs to be noted – addressing climate change is not only part of ESG reporting, but a critical part of risk management. It's the impacts on the company itself that are also important.

What needs to be done?

So we have looked at why company secretaries have a role in climate risk, but the next question is how you should fulfil this duty. The TCFD report released in July 2017, though formally about disclosure by companies and asset managers, provides a useful framework for companies to manage their risk. As this framework is likely to be what investors will be looking at – and it is in part directed at investors and insurers – it makes sense for companies to use it as a guideline. It has four parts to it.

1. Risk assessment procedures

Though easy to understand in principle, having regard to our categories of risk above, this is complex to assess in practice. One way to begin is to make use of a risk tool that provides a framework as well as some of the evidence for your analysis. A risk tool has been designed for Hong Kong businesses by Business Environment Council Ltd (BEC) Climate Change Business Forum with the assistance of PricewaterhouseCoopers. This enables companies to enter information as to the different parts of their business and obtain a heat map. It's a starting point for a detailed analysis. For that analysis, you may wish to commission internal or external experts to look closely at particular risks.

2. Metrics for measuring impact and targets

As we all know, it's very hard to measure progress without metrics. What would these be? They could range from a meaningful measure of your carbon intensity (energy usage) per square foot. This may be what your business can control in practice and what you should focus on. Simply counting carbon emissions may not be as helpful as those figures will change as the carbon intensity of generation changes. Targets to manage risk and opportunity as well as performance against these targets is another aspect of this framework.

3. Strategy

This reflects growing investor interest, not so much as to how carbon intensive a business is, but what its plans are to change. For example, in deciding on an airline to invest in, there may be an interest in whether the company's strategy is future proofed from changing climate policy through plans to increase the energy efficiency of planes and reduce the carbon intensity of its fuel. Targets are intrinsic to a good strategy. A strategy without a target may not help garner the support of different parts of an organisation.

4. Good governance structures

All the above are part of good governance, but we must not forget good structures too. Company secretaries will understand the role of the board and the importance of ensuring the board is aware and engaged in moderating a big risk such as this.

The TCFD recommendations advise that companies cover these aspects in reporting on climate risk, and the report provides detailed guidance on a sectoral level. Company secretaries may of course ask how this approach relates to of Hong Kong Exchanges and Clearing Ltd (HKEX) requirements. The main difference is that the TCFD approach is about investors looking ahead – at whether a company is resilient to risk. It is therefore more about processes in place to manage risk including governance, risk assessment, strategies, metrics and targets. Past emissions are of course part of the picture but the more critical aspect of good risk management is forward-looking. HKEXs 2016 Guide requests details of current emission levels, and asks for disclosure of the relevant company policies which may include those addressing climate change as well as measures to mitigate emissions and results achieved.

Another important tool recommended in the TCFD report is scenario analysis. This is a useful tool for thinking ahead and taking on trends and future uncertainties, and it is becoming more widely used by businesses to develop business strategies and manage risk. It helps with spotting those weak signals which are a precursor of change that can suddenly fundamentally transform the business environment. We may only see weak signals for change but all of a sudden that change may be upon us. For example, early in the last century it took London just eight years to change from fully horse-drawn carriages to internal combustion engine vehicles. With climate change, a similar scale of change in the way we do things may just happen. Businesses need to be prepared for this with good systems of risk management and processes to spot those business opportunities inherent in the changing landscape.

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This article should not be regarded as offering advice on legal duties and obligations. For such advice, you will need to seek independent advice in the usual way. This article should also not be regarded as an official view of BEC and its members.

The Taskforce on Climate-Related Financial Disclosures report mentioned in this article is available online at: https://www.fsb-tcfd.org.

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