What should be on the board agenda for climate risks

It starts with asking pertinent questions and considering key issues on the governance and management of threats and opportunities. BY KHOO GUAN SENG AND MAK YUEN TEEN

Climate change can disrupt business operations, evaporate demand, impose obsolescence and shrink market share. PHOTO: AFP

WHILE directors and other corporate leaders are generally aware of the risks of climate change, many may not understand well the specific impact that climate change will likely have on their businesses.

Failing to properly consider climate change may pose an existential risk for some companies, while others may see their profitability significantly eroded. Responsible businesses also need to consider how their operations affect stakeholders at large.

The effective oversight and management of climate risks and opportunities requires the board of directors to set the right tone, so that employees believe that sustainability truly matters and that their company addresses it effectively.

It starts with the board asking pertinent questions and considering key issues on the governance and management of these risks and opportunities.

Since climate risks may be seen to crystallise over periods exceeding tenures of directors and senior executives, and beyond time horizons covered by incentive plans, they may not receive attention beyond complying with regulatory reporting requirements.

While their major role is oversight and monitoring, directors also need to step up in their advisory role and be stronger advocates in addressing this issue. Directors themselves have to upskill in this area; this requires more than just attending mandatory climate-related training imposed by regulators, which may be focused more on compliance and reporting.

In a forthcoming report titled *Board Oversight of Climate-Related Risks and Opportunities*, the second in the *Foresight* series published by CPA Australia and Sustainable Finance Institute Asia, we discuss 10 questions that directors should ask about climate change and provide our views on important issues to note in relation to these questions.

The questions are intended to provide a structured approach for boards to approach this difficult topic:

- What are the board's responsibilities relating to climate risks and opportunities, and how can we effectively discharge these responsibilities?
- What are the main pitfalls relating to climate risks that our company should be aware of, and what are the consequences if we do not address them?
- How will the different types of climate risks affect our company and business?
- What are the strategic and critical climate risks and opportunities that our company should address in order to remain sustainable?
- What corporate objectives and strategies should our company adopt, to address climate risks and opportunities?
- How can we set our company's climate-risk appetite, especially since the transition pathway involves a journey into the future?
- What risk-management framework and measures should our company have in place to ensure effective climate-risk management?
- Are our climate-related metrics and targets appropriate, should they be linked to executive remuneration, and how to monitor the progress and achievement of these targets?
- What information should our company disclose about our climate-risk governance and management, and how can we ensure the information is reliable?
- Is our company exposed to accusations of greenwashing, and how can we mitigate this risk?

Here, we summarise some of the key issues relating to the 10 questions.

The board's top tasks

First, the board needs to be clear about its responsibilities relating to climate risks and opportunities. Sustainability reporting frameworks are useful starting points for identifying the key issues related to sustainability-related risks and opportunities relevant to the business.

It is crucial that every company conducts a robust materiality assessment of its environmental, social and governance (ESG) risks, including climate risks.

To oversee the risks and opportunities, the board must install an appropriate governance structure and acquire the relevant expertise. It is essential to adequately understand the impact of climate risks on the business. In part, this requires the board ensuring that the management conducts in-depth analysis of good data relating to climate risks and opportunities relevant to the organisation. The board should steer the company towards adopting an integrated strategic approach for addressing the climate risks and opportunities.

Beware these pitfalls

There may be harsh financial, legal and reputational consequences if a company does not do enough to assess and address its climate risks.

In particular, boards should be wary of climate-risk blind spots, failure to comply with regulatory requirements, and contagion risk exposure from climate change. There should be constant boardroom dialogue on climate change and strategies, policies and practices to address climate risks and opportunities. It is equally important for the board to keep abreast of developments in this area.

Business impact

In order to respond effectively to climate change, the board must first understand how the different types of climate risks affect the company and its business. Climate change creates physical and transition risks. Physical risk is associated with resource, operational or programmatic impairment of economic activity attributable to climate change.

Transition risk is associated with the uncertain financial impacts that could result from a transition to net-zero emissions or a low-carbon economy.

Climate change makes its presence felt in the business world in a wide range of ways. For example, it can disrupt operations, evaporate demand, impose obsolescence and shrink market share. Recent academic studies have concluded that climate-related factors affect risk premia, cost of capital, stock returns, and other outcomes.

At the same time, climate change brings business opportunities, such as those linked to climate-change mitigation and adaptation solutions, and the transition to a low-carbon economy.

Addressing risks and opportunities

A key element of sustainability is the ability to adjust well to climate change. A company's strategic and critical measures on this front should include changing mindsets; reducing the dependency on traditional energy sources in a meaningful and substantive way; and identifying opportunities arising from the decarbonisation of the global economy.

The energy transition demands an enterprise-wide mindset change, which must start with the board of directors. It is also part of the board's duties to ensure that the company's human capital strategy and hiring policy support its climate mitigation and adaptation efforts.

In our report, an independent director of AET Tankers – a global leader in energy logistics solutions and the petroleum arm of MISC – explains the company's business model change for the medium to long term, relating to its current climate-change and sustainability initiatives.

He also shared the company's strategic thinking for the long term as it seeks new business opportunities, whilst managing its energy transition and meeting the UN Sustainable Development Goals.

Twin paths of mitigation and adaptation

The journey towards net zero will require mitigation and adaptation. The mitigation pathway entails the firm adopting mitigation strategies to reduce greenhouse gases and energy consumption in general. Adaptation is about lowering the risks of being hit by the consequences of climate change and creating resilience.

The board's primary role in this area is to set objectives and strategies for the company's mitigation and adaptation efforts.

Setting a climate-risk appetite

A company must determine its climate-risk appetite. The board is expected to understand the company's financial risks related to climate change, satisfy itself that the climate-risk assessment process is robust, and oversee the management of these risks within the overall business strategy and risk appetite.

It is best that the climate-risk appetite statement covers transition and physical risks and is aligned to scientific-based climate-related objectives. Because of the nature of climate change and climate action, a company's climate-risk appetite needs to constantly evolve to suit the shifting scenarios.

A company may also want to set its long-term climate-risk appetite because some climate risks may take far longer than the conventional strategic planning timeframes to materialise.

Effective climate-risk management

After setting its climate-risk appetite, a company should adopt a framework for managing this risk and put in place the appropriate measures.

This framework can be based on existing risk-management frameworks created by credible international bodies, or on entity-specific risk-management frameworks. Climate-risk management requires a proactive holistic approach, with emphasis on business continuity and contingency plans as well.

Internal audit can provide the board and management with assurance for the adequacy and effectiveness of the company's climate-risk management framework and measures.

Metrics and targets

For many companies, environmental- or climate-related risks would be expected to be a material ESG factor. Where they have not been identified as such, boards and management should be mindful that they are not missing climate-related blind spots.

This then paves the way for the setting of climate-related metrics and targets. A company's climate-related metrics and targets should be selected based on the climate risks and opportunities that are most relevant and material to the company and its stakeholders.

One approach to identifying relevant metrics is to start with sustainability reporting standards. Appropriate targets related to the selected metrics, aligned with the company's goals, commitments and mandatory requirements, should then be set.

Related issues are whether to link these metrics and targets to executive remuneration, and how to best monitor progress and achievements. Adequate board oversight is key to ensuring the usefulness of the metrics and targets.

The power of disclosures

Disclosure of material climate-related financial information is key to the transition to a low-carbon economy. When a company reports this information, it sheds light on its climate risks and opportunities, and the progress of its decarbonisation initiatives.

The process of gathering and presenting the information itself can nudge the company towards doing more for sustainability. There are rapid developments in the regulation of and the standard-setting for sustainability reporting. Companies must have the resources and expertise to comply with the evolving rules and standards.

The board should also consider the role of assurance in ensuring high-quality sustainability reporting, including weighing the option of hiring an external assurance firm.

Avoiding the taint of greenwashing

Regulators and other stakeholders are paying more attention to greenwashing. Companies that try to appear environmentally conscious – when their business practices are not – have reason to feel vulnerable because greenwashing exposes companies to financial and reputational risks. Their directors may be the targets of regulatory and private actions.

To mitigate the risk of being accused of greenwashing, companies and boards should first commit to being open and transparent. Their sustainability reporting should be augmented with strong governance, a robust "three lines" model to help ensure sturdy and proper internal controls, and independent assurance.

It should be noted, though, that sustainability assurance cannot be regarded as a panacea for greenwashing. Engagement with stakeholders, including non-governmental organisations, can also help companies to better understand concerns about greenwashing.

Ultimately, effective oversight of climate risks and opportunities must be based on a firm foundation of good corporate governance, adapted for an ESG world.

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