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SPECIAL REPORT Q&A March 2022

ESG and climate risk management

FW discusses ESG and climate risk management with Pierre Taillefer at BDO Canada, Silke Goldberg at Herbert Smith Freehills, Adrian Walker at Hogan Lovells and Paul A. Davies at Latham & Watkins LLP.

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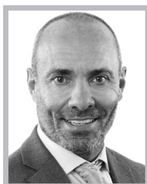
THE PANELLISTS



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FW: How would you describe the evolving climate risk landscape, and the challenges it presents to companies? In your experience, how focused are companies on climate risk?

Taillefer: Climate risk is a rapidly evolving issue. With increasing stakeholder demands for environmental, social and governance (ESG) transparency, coupled with current and expected mandatory requirements in the European Union (EU) and a variety of other jurisdictions across the globe that will impact financial and non-financial ESG reporting, organisations should consider making the investment now to build an ESG strategy, with a focus on climate-risk management. Currently, there are multiple reporting frameworks, each with their own set of disclosures. The lack of a harmonised reporting framework is challenging as companies are neither reporting on the same metrics nor are they making the same disclosures. As a result, it is difficult for investors and capital providers to evaluate companies' progress on addressing climate risks consistently, which may hinder effective capital allocation decisions. Both the Canadian Securities Administrators and the US Securities and Exchange Commission (SEC) are developing climate-related disclosure requirements guidance. As a result, we are seeing an uptick in companies paying closer attention to climate risk and emissions management in anticipation of new regulations. Last year in the US, the SEC requested public comment on the need for climate risk disclosures and released a sample comment letter which highlighted existing 2010 guidance reminding companies of their duty to disclose material information even if not expressly required by rules. Further, the SEC has signalled that in early 2022 it expects to issue proposed regulations regarding human capital and climate disclosures.

Walker: Climate risk is existential, and the landscape is changing very fast. So, companies are naturally very focused. We have seen a sea change in the focus level over the last five years and especially over the last two. Risks encompass regulatory compliance, consumer and investor pressure, recruitment and retention, shareholder activism, liability for environmental damage and climate-related disruption to supply chains, demand failure, economic activity and cost of capital. It does vary by sector though and, sometimes, those most exposed have had the strongest incentives to get ahead of the pack. Risk and cost is the wrong mindset though. Opportunity and sales, linked to a strong ESG brand, as well products and services which are aligned to consumer and other stakeholders' ESG values, is a better paradigm. Think of it in terms of 'upside opportunity and revenue – not risk and cost'. That approach also happens to be the best risk mitigation.

Davies: While ESG matters present both challenges and opportunities, one of the main ESG challenges for many companies is how to address climate risks. As Larry Fink noted, there is no company whose business model will not be profoundly affected by the transition to a net-zero economy. In particular, as climate change issues become increasingly pervasive in company strategies, disclosures, enterprise risk management, the global financial system and commercial transactions, associated litigation very likely will also proliferate, with current trends supporting the rise in such litigation. We do not expect these trends to dissipate anytime soon. Large multinationals, along with governments, currently continue to be the primary target of non-governmental organisations (NGOs), activists and similar organisations. As such, we see that such multinationals – particularly those in climate-sensitive sectors – are developing resources to manage and mitigate these risks. However, there are still a number of large companies and small and medium sized enterprises (SMEs) that have taken very limited steps.

Goldberg: The overall climate risk landscape is ever increasing. This is most apparent by the sheer increase of physical climate impacts experienced around the world in 2021 alone, from floods and forest fires to storms and droughts. The immediate impact of a changing climate can already be felt today. Due to this increase in these tangible physical risks, the reputational risks deriving from climate is also being felt by businesses, which are reacting to this pressure with climate

pledges and a renewed focus on climate matters. Coupled with the additional regulatory pressure, as climate-related regulation is increasing around the globe, businesses are forced to consider climate as a priority on their agenda or risk falling behind. Generally speaking, some sectors are further ahead than others, largely due to the fact that for some sectors, such as energy, climate has already played an important role for a while. However, in the new business environment, other sectors are forced to catch up and are required to quickly understand their exposure to climate risk. This has been illustrated by the UK's implementation of mandatory climate-related financial disclosure obligations under the Task Force on Climate-Related Financial Disclosures (TCFD) for all UK-listed companies.

FW: Drilling down, what steps do companies need to take to embed climate-related risks in their business operations and environmental, social and governance (ESG) risk management frameworks?

Walker: Companies need to think in terms of a corporate 'ESG 360' approach. Start with your corporate purpose, then your goods and services, then your stakeholder expectations. Once you are clear on that and how that resonates in an ESG and climate risk world, you can move to the next level, but you may need to completely rethink your purpose and so on. Also consider whether your thinking is reflected in your business model and risk management framework, in order to consistently drive the right behaviours – that starts with governance and flows through policies, procedures, incentives, the supply chain, and terms and conditions. It is quite a radical shift and is more than skin deep. You need effective science and data collection systems. This data is not only important to access finance and comply with regulations – reliable data will also highlight risks and opportunities and facilitate a robust business strategy to manage ESG risk. Artificial intelligence, machine learning and the internet of things will help to monitor and improve compliance and operational efficiency.

Davies: As the pandemic has shown, planning for every eventuality is impossible. However, companies can anticipate and mitigate ESG risks. One means of doing this is through the implementation of early-stage risk screening and incorporating ESG risks into the company's overall enterprise risk management (ERM) exercise. In particular, the framework of the TCFD's recommendations has rapidly established itself as best practice to collect data, assess and report on climate change risks. This is particularly the case as we see some countries adopt the roll out of mandatory TCFD reporting, and the global standards emerging from the International Sustainability Standards Board (ISSB) appear likely to incorporate relevant aspects of TCFD.

Goldberg: To embed climate-related risks in business operations and ESG risk management frameworks, companies need to primarily be able to understand climate risk, and the company's exposure thereto. For this to be possible, a number of things are needed, including a strong and ambitious internal policy framework and an internal governance structure that is fit for purpose. Companies should also have robust internal data collection procedures to ensure they have the information they need to understand and identify related risks and that all data is available for reporting obligations. The integration of climate considerations at all levels of the business, not only at board level, is also crucial, as is training for the board and all other employees, so that climate risk can be identified and understood, with climate-related targets set and reported on. Overall, it is important that all of the above become part and parcel of companies' overall risk assessment and business and compliance strategy.

Taillefer: Whether a company is activating its ESG programme or is further down the path and has developed a sustainability programme, the foundational elements and steps needed to embed climate-related risks into its business operations are the same. First, it is important for companies to understand and prioritise the material climate and other ESG risks prevalent in the industry sector in which they operate. This entails determining the priorities of their relevant stakeholders, evaluating existing sustainability efforts and understanding where the company stands in integrating ESG into its operations relative to its peers. This process helps leadership drive the greatest impact from their climate-related initiatives – be it mitigation through reducing its carbon footprint or use of carbon credits, as examples. Climate risks are generally categorised

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> Latham & Watkins LLP

as either physical risks – the impacts of extreme weather events or rise in sea level or transition risks associated with moving toward lower-carbon producing operating models. After determining material ESG and climate risks, leadership should focus on developing a climate strategy, prioritise climate risk-related mitigation initiatives to reduce greenhouse gas emissions (GHG) and set emission targets. In addition, establishing a set of baseline metrics and regular tracking of progress against emissions and other ESG targets are key to external reporting under a wide variety of reporting frameworks. Leading ESG reporting practices include implementation of technology solutions to capture, analyse, monitor and report on ESG metrics to ensure the reporting process is both efficient and effective.

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>
> ADRIAN WALKER
> Hogan Lovells

FW: How would you characterise the regulatory and commercial pressure on companies to protect their balance sheets from the impacts of climate change? What role does scenario analysis have to play in this regard?

Davies: Mark Carney, in his former capacity as governor of the Bank of England and chair of the TCFD, highlighted the "tragedy of the horizon" and we see that financial regulators are increasingly concerned about the potential for climate change risks to result in financial instability. Currently, such regulatory pressure in relation to balance sheet risks and climate change is primarily targeted at financial institutions, in particular, banks, insurers and pension funds. However, we expect this to expand to all companies in the value chain. Part of this will be driven by mandatory climate change disclosures. Most notably, TCFD provides for scenario analysis. The undertaking of this scenario analysis will highlight the longer-term physical and transition risks associated with climate change. While such focus is not widespread across all companies and sectors, we do expect this to change in the coming years.

Taillefer: Regulatory pressures are currently focused on transparency and disclosure which are serving to raise awareness and drive a call to action around addressing climate risks. Commercial pressures, on the other hand, tend to focus on value creation and alignment with the global sustainability agenda. For example, banks and capital providers have implemented new loan criteria and are formalising rules for climate-risk management. If companies do not manage climate-related risks, they may become exposed to value erosion that could undermine their credit status. Scenario analysis and stress tests will be critical in helping capital providers assess resilience across their portfolios. This will help guide banks as they estimate potential damage that could be caused by climate change. Since regulators are prioritising stress testing and scenario analysis, it is important for companies to actively manage ESG issues and implement the necessary technology to track emissions and other climate-related disclosures.

Goldberg: The sheer amount of climate-related regulation around the globe poses challenges for companies. In addition, forward-looking regulatory risks pose a particular risk to carbon-intensive sectors which may be faced with stranded assets in the future. In this context, it will be interesting to see how the COP26 coal phase-out will develop over the coming years. At the same time, customers and the wider public are placing much more emphasis on climate matters, which puts immense commercial pressure on companies to transition their business to a more climate friendly future. This can be seen in particular by the change of direction taken by some large oil companies to increasingly diversify their portfolio and invest actively in renewable energy assets. This does show that beyond the pure balance sheet, a large part of the climate debate has reputational impacts on companies, which is acting as a key driver for change. Companies might also be affected by climate change themselves and need to change their supply chains as a result. In order to understand possible future risks and opportunities for companies, scenario analysis is essential, and is also recommended under frameworks such as the TCFD.

Walker: The risk is existential, and the regulatory wave looks like a tsunami. The real challenge is that it is evolving in parallel across multiple jurisdictions. Supply chain and market complexity means companies need to comply with multiple, fast-evolving rules. On top of that they need to build business models that are fit for purpose under all systems. It is a bit like trying to build a finance system that complies with multiple accounting standards. There is an amplification effect as commercial stakeholders, including

debt and equity, are overlying their own requirements, and that translates to increased cost of capital or other stresses if your climate approach is not robust. Scenario analysis, including traditional tools such as Monte Carlo risk modelling and climate modelling, as well as associated science, is inevitably becoming more sophisticated and allows companies to assess the impact of future risks and opportunities arising from climate change across their value chain, make the necessary preparations and demonstrate their resilience to stakeholders.

FW: Generally speaking, how comprehensive and accurate are companies' climate risk and ESG-related disclosures? Is there a need for improved assessments and greater standardisation?

Goldberg: There has been a considerable increase in the adoption of the TCFD framework by companies over the past year – a development which was in part driven by the UK's adoption of TCFD as the mandatory framework for premium-listed companies, and from 1 January 2022 onwards for all listed companies. While an increasing number of companies are reporting on climate and ESG matters, the quality of these disclosures still varies immensely. In addition, with the increasing focus placed on climate matters, as well as wider ESG considerations, a related risk is greenwashing. As companies are trying to present themselves as part of a net-zero future, emphasising their steps in meeting the new climate-related expectations levied on them by customers, lenders and shareholders, there is a high risk of overpromising or mislabelling their products. While this may be beneficial to some companies in the short term, greenwashing poses a substantial litigation risk, and regulators are increasly looking at the quality of disclosures and are taking more active steps against greenwashing. Greater standardisation in the disclosure space would help to address greenwashing while also providing for more reliable comparability between companies. This would help the true leaders of the climate transition and identify stragglers, further motivating active investment in decarbonisation and future technologies.

Walker: Much of the market is at the start of its journey here. The quality varies hugely and the science is evolving. But disclosure requirements are going to get more comprehensive fast. Everyone knows that, so I think people have moved away from thinking about fighting defensive rearguard actions on disclosure – it is a doomed approach. Mandatory disclosure and reporting requirements for companies depend on a number of factors, including whether the company is a public or private entity, the size of the company and the industry in which the company operates, for example regulated companies may come under greater scrutiny. I feel sorry for businesses with all the differing new laws, such as the TCFD in the UK and the EU approach, and with new SEC rules on the way.

Taillefer: Due to the lack of a harmonised reporting framework and standardised disclosure requirements, the climate risk reporting landscape is fragmented. Currently, companies can choose to report on climate risk disclosures from a variety of frameworks, each with their own set of metrics and often in a format of their choice. This, combined with the fact that third-party assurance on ESG reports is not mandatory, creates a strong argument for improved assessments and greater standardisation. Steps are being taken to improve the accuracy of companies' ESG-related disclosures. In November, the IFRS announced a new International Sustainability Standards Board to develop a comprehensive global baseline of high-quality sustainability disclosure standards. This is a significant development to fulfil the growing and urgent demand for a formalised corporate sustainability disclosure framework and is an important step in preparing for mandatory ESG reporting requirements coming to financial statements for various jurisdictions in the near future. One such jurisdiction is the EU, where new regulations with respect to ESG reporting and attestation are being drafted under the Corporate Sustainability Reporting Directive (CSRD). Both private and public companies with operations in the EU that meet two of three size thresholds – stated in total assets, revenues and employees – will be required to report on a variety of ESG-related topics commencing in 2023, with a subset of smaller entities required to report in subsequent years.

Davies: Our overriding message is to treat public disclosures in relation to ESG matters, including climate change matters, as seriously as those deployed

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>
> SILKE GOLDBERG
> Herbert Smith Freehills

in respect of financial disclosures, and to adapt similar processes. Companies are starting to acknowledge the need to take such steps and are implementing independent auditing and verification steps, particularly for annual ESG-related reports and other material ESG disclosures, such as disclosures relating to climate change risk. If regulation is likely to mandate future compulsory ESG disclosures, such as in respect of TCFD or forthcoming SEC disclosure obligations, this will become even more important.

> REGULATORY PRESSURES ARE CURRENTLY FOCUSED ON TRANSPARENCY AND DISCLOSURE WHICH ARE SERVING TO RAISE AWARENESS AND DRIVE A CALL TO ACTION AROUND ADDRESSING CLIMATE RISKS.
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> PIERRE TAILLEFER
> BDO Canada

FW: In the wake of the COP26 climate summit, how are companies, regulators and risk managers likely to respond in terms of taking tangible action toward carbon reduction targets? What key risks will they need to manage along the way?

Walker: Think of it as a competitive sport where the ultimate regulator is the 'crowd'. If the smartphone-empowered crowd does not like your corporate position they will not buy, and they may call you out publicly. COP26 is really a manifestation of that crowd pressure. The crowd moves faster than regulators and risk managers, and where companies get ESG wrong, we see billions wiped off a balance sheet in a day of tweeting. I call that 'crowdreg'. Companies are increasingly committing to net-zero target dates. For example, Apple has recently committed to being 100 percent carbon neutral in its entire business, manufacturing and supply chain, and product lifecycle by 2030, 20 years sooner than the Intergovernmental Panel on Climate Change (IPCC) target. I think we will continue to see consumer and corporate led global approaches cross fertilising regulatory benchmarks and dragging up the market. This corporate and crowd approach can also stretch beyond national regulatory boundaries. One of the key points to come out of COP26 was the current paucity in emissions information. Without that, it is impossible for consumers, investors and regulators to make informed decisions. New regulations and associated science and market education is starting to address this, but it is a big task.

Taillefer: In the wake of COP26, hard action is being taken toward carbon reduction. We are seeing companies take tangible steps toward environmental management. As part of an overall sustainability programme, managing carbon emissions is one of the key environmental issues that companies, and risk managers, are prioritising. As both the Canadian Securities Administrators and the SEC are taking tangible steps to ensure companies report on climate risks, corporate leaders should begin mapping out their plans to achieve net-zero. Managing carbon risk is not easy and must be addressed across the entire organisation. Corporate leaders need to understand a diverse set of operational risks and opportunities associated with everything from requirements set by GHG regulators to the carbon footprint associated with its supply chain. The ability to track and monitor emissions and accurately report to stakeholders – governments, investors, regulators, customers and employees, among others – are some of the key considerations that companies must start managing and implementing into their business operations.

Davies: Governments increasingly announce net-zero carbon targets or carbon reduction targets. This is likely to develop further over the next year as countries are required to submit their nationally determined contributions ahead of COP27 in Egypt. This is continuing to result in downward pressure, and we see those companies yet to make their own commitments, coming forward to establish carbon-neutral or carbon-negative pledges. We expect these commitments and the rise of mandatory ESG or climate disclosures to continue to further the trend of climate change-related litigation. Companies will need to take steps in relation to disclosures and will need to establish targets or agree to standards or commitments they can achieve. Those companies that do not manage disclosure risks or establish overly ambitious targets will face greater exposure to litigation risk and damage to their brand and reputation.

Goldberg: At COP26 it became apparent that the private sector has taken a leadership position and shown a willingness to act where governments have shied away. This was further supported by the clear narrative from governments that the private sector is to play a pivotal role in the transition to net-zero. However, the important question is whether actions will follow pledges. To fully enable the private sector to make the required changes, it is important that regulators are taking a collaborative approach to aid rather than hinder the deployment of essential technologies for a net-zero future, and to understand legal limitations

currently in place. This will include setting ambitious standards to motivate and drive decarbonisation, while also setting a level playing field that rewards decarbonisation rather than inaction. Yet, only time will tell how ambitious the economy will be in actually tackling the challenges ahead, and if the targets and pledges entered into by multinationals were so set with an intention of being met, or only a reaction to market pressures. There are many companies that are targeting a true transition; however, what is needed is an economy wide transition for true change to take place.

FW: What essential advice would you offer to companies on planning and implementing climate-related risk strategies? What considerations do they need to make when framing metrics and targets to assess and manage ESG issues?

Goldberg: The consideration and integration of climate risk into business strategy has become a question of survival rather than a nice-to-have, and it is essential for companies to get their ducks in a row now, as some will struggle and are unlikely to survive in the long term. However, to be able to implement a meaningful climate strategy and appropriate targets, it is essential for a business to properly understand its exposure to climate risks and their impacts on the business as a whole. This will require relevant data and information of the specific business, which has to be gathered first. Once this has been successfully assessed and understood, targets have to be set not with a market expectation in mind but based on the business itself and the transition it is able to support in the time frame intended. ESG issues and climate change should not be viewed as another compliance exercise, rather a paradigm shift that needs to be addressed at every level of a company. Therefore, the time to act is now to integrate ESG and climate change at the heart of everyone's business. For this assessment it is highly recommended to obtain professional advice to implement resilient systems that support the company in a turbulent climate future.

Davies: It is important that companies build out the requisite ESG knowledge and resources that provide a company with the tools required for the management and strategic oversight of ESG matters and ESG risk. Some companies may want to revise their governance arrangements through line management to the senior management team and include appropriate ESG oversight at board level. There are many ways to achieve this, for example the addition of ESG matters to the responsibilities of the governance or risk committees of the board, or giving one or more non-executive directors responsibility for ESG matters. Integration of climate risk into a company's ERM process should become the norm, and this should not be limited to physical risks, but also transition risk.

Taillefer: We advise all companies, whether public or privately held, to start actively managing ESG risks now, and addressing climate-related risks should be a high priority. If companies choose to delay in getting started, they may find themselves unable to compete and may lose their social licence to operate. The ability to attract and retain talent, secure capital from banks and investors, and attract customers will all be impacted if a formal, public-facing ESG strategy does not exist. The benefits of doing so are very real and create corporate value by establishing a broader, longer-term vision.

Walker: You have to start with who you are as a business and what you want to be in this space. You need to develop your thinking in harmony with all your internal and external stakeholders – I cannot overemphasise this. Collaboration is key. Like Aristotle said, "you are what you repeatedly do", not what you say you do. So think about delivery and remember that in this space, from a consumer and regulatory perspective, it is better to not promise at all than to make fake or undeliverable promises. Overdeliver – do not over promise. And make sure you get the science behind your report right – it is complicated and without a rigorous scientific approach you are going to fail.

FW: Looking ahead, do you expect to see companies increasing their focus on and oversight of ESG and climate-risk issues? How confident are you that the target of net-zero greenhouse gas emissions by 2050 or earlier can be achieved?

Davies: The focus on ESG, including climate change, risks is only set to continue. To manage these risks, companies will want to consider their ESG data collection and ESG systems to support any build-out and extension of ESG knowledge. This would require investment and a clear corporate strategy that is aligned with their internal reporting – including the ERM process – and external disclosure models. If companies undertake external disclosure on ESG matters, whether compulsory or voluntary, they will need to reflect on the reputational and associated litigation risks that will arise from this approach and make assurances on its effectiveness. Such an approach will also place demands on compliance and audit functions, both internal and external. Government targets of net-zero by 2050 will be very challenging to achieve, particularly in the context of the expected increased demand from developing economies. Material investments by state and non-state actors will be needed, as well as difficult policy choices, in order to deliver the fair and just transition to net-zero.

Taillefer: We are seeing companies increase their focus and oversight of ESG issues and climate risk within their business. We expect this trend to grow with increasing stakeholder demands and increasing mandatory jurisdictional reporting requirements in the near future. Most companies are aware that they need to start managing ESG issues and publish an ESG report, but many also understand that – beyond compliance – there is a broader opportunity to benefit all stakeholders and generate long-term value for the business. The issue we are seeing is that there is a knowledge gap in how to map a scaleable ESG journey. We are confident that the target of net-zero greenhouse gas emissions by 2050 can be achieved with further education and collaboration

between government, business and society. If all relevant stakeholders are purpose-driven and work together, this target can ultimately be achieved.

Walker: I am confident the 2050 net-zero target can be achieved, but the challenge is whether it will be achieved. I am a firm believer in the incredible power of consumers and business as a big lever and driver of innovation. With a $70 trillion estimated climate market through to 2050, there is an obvious bottom line incentive. What keeps me awake at night is the deep political divisions, economic nationalism and the issue of whether the global north can find a way to empathise with the global south and fund a 'just transition' in a way that gets us on climate track. I think business will need to lead here.

Goldberg: To survive, businesses will have to place an ever-increasing focus on climate and ESG matters, generally. This is because climate risks are so diverse they can affect every aspect of a business. While some businesses may not be net-contributors to the climate crisis, they may nevertheless be directly affected by physical climate risks which could directly threaten their operations. Whether net-zero will be achieved is a question of ambition requiring cooperation on a global scale. While we cannot predict whether this will be achieved, it is clear that if net-zero is not met in the near future or 2050 at the latest, there is no question that the resulting consequences will be much more expensive and invasive than a transition to net-zero would have been. ■

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