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Brief

Disclosing Climate-Related Risks: Current and Future Prospects

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Abstract

FEEM Policy Brief

This policy brief draws upon the issue of Climate-Related Risks (CRR) for the private sector, and the approaches firms adopt to disclose their exposure in transitioning towards a low-carbon economy. Specifically, it illustrates the recent developments in the field of climate-related financial disclosure, provided by the Financial Stability Board (FSB). Further, it outlines the findings of FEEM's DeRisk-CO report (Disclosure, Measurement, Management and Mitigation of Climate-Related Risks for Companies), to give an example of how some major Italian companies are operating in this field.

01 The tragedy of the horizon: acknowledging the issue of climate change in the private sector

The entering into force of the Paris Agreement emphasized the necessity of developing more ambitious and credible actions to face the global risks of climate change. Mitigation policies are a fundamental factor increasing the materiality of carbon risk for investors. Therefore, companies are transitioning towards a lower carbon economy to prepare for emerging institutional measures affecting their short, medium and long-term strategies[1].

In his speech at the Lloyds of London in September 2015, Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board (**FSB**), referred to climate change as "The Tragedy of the Horizon[2]", an overriding global issue whose catastrophic impacts "will be felt beyond the traditional horizons of most actors, imposing a cost on future generations that the current generation has no direct incentive to fix" (Carney, 2015, p.4).

Carney highlights the necessity of responding to Climate-Related Risks (CRR), on account of their critical implications for both private organizations and investors. In this respect, the FSB individuates two main categories of CRR, namely physical and transition risks. The former includes all the physical repercussions of disruptive events such as floods or storms (acute risk) and of longer-term shifts in climate patterns (chronic risk), which compromise the capacity and continuity of productive processes all along the supply chain. The latter includes diverse scopes of risk (policy, legal, technology, market, reputation), linked to costs and opportunities that are redefining the value of a number of assets.

A clear example of how such risks can be detrimental to an industry and the economic system is that of fossil fuel companies.

As estimated in the report by Mercer (2015), the median additional annual returns of coal and oil firms are expected to drop to around -4% in a 35-year horizon.

In addition, Weyzig et al. (2014) calculate the exposure of 43 main European institutional investors (Insurance companies, pension funds,

[1] See "A review of international financial standards as they relate to sustainable development" (UNEP, 2017)

[2] Carney evokes the more renowned "Tragedy of Commons", first appeared in Hardin (1968)

banks) to the carbon bubble and compute their potential losses in different scenarios of economic transition toward a 2˚C emissions scheme. The carbon bubble is the fast depreciation of fossil reserves, which become stranded assets, in the path of decarbonization imposed by international agreements to tackle climate change. Such a loss of value, beyond threatening the survival of oil companies, substantially endangers the financial institutions in the study, which overall own 1,061 billion euros of fossil fuel firms' debt. This circumstance not only creates concern of directly involved capital owners, but it can also propagate to the broader economy, especially in times of economic and financial distress.

02 TCFD guidelines: voluntary disclosure of Climate-Related Risks

In this context, the Financial Stability Board's proposes a framework that can orient companies on the way to a reliable and internationally acknowledged procedure to identify, manage and respond to the risks of climate change. **The Task Force on Climate-related Financial Disclosures (TCFD)**, created in December 2015, is composed of 32 representatives of international private organizations and aims at promoting more informed investing, lending and insurance underwriting decisions. The guidelines provide detailed recommendations on how to disclose risks and strategies to cope with CRR. Besides, the TCFD suggests that organizations reveal information on parameters, assumptions, methodologies and analytical choices employed for each analysis, as well as the related financial impacts.

The framework covers four thematic areas, namely governance, strategy, risk management and metrics & targets. In particular, organizations are asked to disclose the processes and frequency by which the board is involved in the supervision of CRR and to redefine the role of management in this respect. Also, the guidelines propose to describe how both risks and opportunities are identified in the short, medium and long-term and how these affect the corporate strategy. Finally, companies should provide every information that could help investors to evaluate better risk-adjustment returns, their ability to meet financial obligations, their general exposure to climate-related issues and their progress in managing or adapting to those issues (e.g. Scope 1, Scope 2 and, if appropriate, Scope 3). Notice that the recommendations for each thematic area are complemented by specific references to other international voluntary frameworks (e.g. G20/OECD Principles of Corporate Governance, CDP, GRI G4, IIRC) that preparers can use as additional guidance tools.

As a further contribution, the TCFD explicitly encourages organizations to complement their disclosure with a set of scenario analyses, such as IPPC and IEA ones, favoring a 2˚C target. Scenarios should include both favorable and unfavorable predictions and integrate information about the parameters, assumptions, and the analytical choices employed.

Overall, the task force's guidelines are not the first attempt to favor climate-related financial disclosure (see, for instance, Carbon Disclosure Project, Asset Owner Disclosure Project). Nevertheless, the novelty of this initiative lies in what seems to be a detailed methodological approach, characterized by specific instructions and cross-references to other frameworks.

03 Framing the Italian business landscape: current profiles and areas for improvement

With regards to the topic of CRR for Italian companies, on May 9th, 2017 Fondazione Eni Enrico Mattei will present the results of the project **DeRisk-CO** (Disclosure, Measurement, Management and Mitigation of Climate-Related Risks for Companies), started in April 2016. The study contributes to the debate on CRR for the private sector, framing practices to address this challenge in the Italian business arena. DeRisk-CO involved a set of major Italian firms operating in the energy-utilities, insurance and agri-food sectors (A2A, Edison, ERG, Hera, IREN, Sorgenia, TERNA, Assicurazioni Generali, UnipolSai Assicurazioni, Cattolica Assicurazioni, Barilla, Ferrero, illycaffè, as well as Telecom Italia and Pirelli). Companies have first participated in a sectorial focus group and then were individually interviewed on their approach to some topics related to CRR: enterprise risk management; evaluation, mitigation and disclosure of CRR; CSR and CRR. In addition, the study covered potential opportunities in terms of firms' business model and strategies, induced by the changing trend of the economic environment. Findings reveal that companies feel the necessity of improving CRR management in response to pressures from both internal (CEO, boards, top management) and external (investors, local authorities) stakeholders. Indeed, the non-financial disclosure is perceived as a fundamental instrument to effectively inform stakeholders on their capability to evolve toward a low-carbon economy. In this respect, most organizations already developed actions aimed at estimating their carbon footprint, but only a few of them are developing climatic models or scenario analysis to quantify the potential CRR on their financial stability in the long term.

Policy conclusions

Current concern about climate change and the related risks encountered by private organizations, especially asset owners and asset managers, pose the need for improving the degree of information about the strategies firms adopt to face them. Rule-makers are taking action in this direction, as the EU Directive (2014/95/EU) on disclosure of non-financial and diversity information suggests. Accordingly, the production of frameworks and guidelines to improve firms' transparency is rapidly growing, even in the absence of a homogeneous standard. The creation and the adoption of a uniform approach for disclosure are what market agents probably expect to be available in years to come. In this respect, the upcoming step in the process will be the release of the European Commission non-binding guidelines in Spring 2017, which will also take account of the contribution of the TCFD.

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