LEAD FROM THE FRONT TO MITIGATE CLIMATE RISK

Frank Morisano
Chief Risk Officer
ICBC

The sustainability boom has brought climate change and the environmental, social, and corporate governance (ESG) agenda to the forefront of the corporate boardroom. Boards of directors are leading the way by enhancing corporate governance, transforming management oversight of business activities, and directing senior management to assess the impact of compliance among their stakeholders.

With one billion people expected to be severely affected by extreme weather conditions and climatic hazards, boards have accepted that climate-related risks will impact their organization. They are confronting the associated financial risk by applying the following five principles:

- Starting the conversation to understand the effects through the lens of long-term value creation.
- Determining whether directors understand the risk impact on their business strategy and growth.
- Ensuring their governance framework is responsive to regulatory and stakeholder demands.
- Guiding senior management to develop the required protocols to address performance metric and disclosure requirements.
- Holding senior management accountable to turn commitments into measurable actions.

1. START THE CONVERSATION

The conversation principle involves the board deploying a leadership commitment to assess whether it has the necessary knowledge and skills to identify ESG risk factors. Effective risk management governance requires a clear alignment between organizational targets and business activities, as products and services that drive profitability today may not be viable in the coming years due to changing climate-related events.

Considering how pervasive the climate topic has become, boards have recruited directors with existing ESG knowledge. However, a greater impact may be achieved by educating the entire board about the topic and its organizational impact. Senior managers such as chief risk officers (CRO) and the general counsel can be instrumental in helping board directors understand climate-related risks, with third parties also playing a role.

2. UNDERSTAND THE BUSINESS IMPACT

A key action for the board is to understand the impact of climate change and ESG-related risks on their business model in the short, medium, and long term. This will enable it to guide the organization in identifying how climate-related risks are met by its products and services, as well as understanding how they affect the risk profile. Such assessments can result in organizational change, including improving strategic planning, modifying risk appetite setting, and expanding scenario analysis and non-organic expansion plans.

ESG risks are difficult to assess and measure as they are highly uncertain, non-linear in nature, and affect organizational assets, sectors, and geographies differently. To address business impact, boards have established central coordination activities and enhanced the roles and responsibilities of their organizational model to improve execution, communication, and messaging. This has been proven to promote a culture of appropriate risk accountability among management and employees.

The champion of this process is most often the CRO or risk executive, as there is interconnectivity between business strategy, climate-related risks, lending decisions, underwriting of net-zero transactions, stress testing, and disclosure reporting. Risk executives have proven to be effective in embedding a climate-related risk framework into the existing enterprise risk management framework, as well as understanding the organization's resilience.

Boards have also championed the creation of departments accountable for disclosure preparation, production, and reviewing; ensuring that climate change and ESG information in the company's financial filings and shareholder reports is correct. The Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) framework is accepted by 60% of the world's 100 largest public companies as the standard for disclosing climate-related financial information to stakeholders, encouraging both forward looking and historical scenario analysis to enhance decision-making.

3. RESPOND TO REGULATORY AND STAKEHOLDER CONCERNS

Regulators and stakeholders want a comprehensive, cohesive account of an organization's ESG commitments. In response, boards have directed senior management to evaluate organizational vulnerabilities and threats. The focus is on categorizing the sub-components of climate-related risks and applying these categories to the relevant asset classes, sectors, and geographies to ensure actions are aligned with stakeholder expectations.

Boards have also brought in third-party experts to help them benchmark their organization against ESG governance industry principles, including adapting risk tolerance measurements, improving risk appetite settings, and enhancing risk management frameworks. Additionally, they have quantified their organization's risk exposure by allowing oversight of climate-related risks under both normal and stressed conditions.

Globally, regulatory guidance can help organizations understand how best to monitor and oversee ESG concerns using four main categories: governance, strategy, risk management, and metrics. For example, the U.S. Securities and Exchange Commission has published guidance regarding disclosure related to climate change to complement the TCFD framework. Since investors want accountability, boards have linked the risk appetite framework and created supporting metrics to gauge climate-related risks. Moreover, boards have expanded staff compensation programs to include achieving ESG milestones and have integrated ESG into the organization's values.

4. DEVELOP METRICS, TARGETS, AND DISCLOSURE PROTOCOLS

What an organization does not understand about ESG is a major concern for stakeholders. Investors require robust disclosure information, including metrics, to fulfill their fiduciary obligations. Rating agencies have been known to factor ESG risks into the assessment of the creditworthiness of public and private sector organizations, not least because climate change can significantly affect cash flows and a borrower's ability to meet their debt obligations.

Recognizing these needs, boards have called for the strengthening of risk frameworks and procedures to ensure the proper controls for monitoring, measuring, and reporting performance. A key consideration is the placement of disclosure reports, which differ based on stakeholder preference. Common platforms include annual reports, proxy statements, sustainability reports, earnings calls, and an organization's website.

Senior management has assisted by focusing its efforts on enhancing internal quality controls to confirm performance metrics. Along with the data collection processes, these usually include a common set of data definitions, transparent calculation methodologies, and tested quality controls. In addition, there must be a common taxonomy to foster greater transparency for investors, specifically for financial products labeled green or sustainable.

5. ENSURE COMMITMENT AND ACCOUNTABILITY

Climate change poses a serious material risk to all organizations. Board commitment has been vital in ensuring an organization is taking adequate steps to prevent and prepare for any damage resulting from climate change; assume its corporate social responsibility to address climate-related risks; and guarantee investor and stakeholder needs are satisfied. Successful organizational accountability requires senior management and the CRO to constantly scan the marketplace, discover new risks, and focus on key business growth drivers.

Success is attained when the board, senior management, and risk executives speak with one voice, ensuring robust climate change and ESG messaging is conveyed to stakeholders. Resilience can be achieved by the board strengthening the organization's risk management ability and reporting capabilities; implementing new tools and enhancing data collection to manage the risk impact; and staying flexible to ensure the right dialogue and monitoring are occurring.

There can be no excuse for inadequate preparation, delayed deliberation, or failure to engage in this complex and continually evolving issue. Regardless of an organization's size or regulatory requirements, both the board and senior management must ensure that discussion of the risks arising from climate change and ESG is a regular agenda item at committee and shareholder meetings.

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