

Factsheet: Climate Related Risk

Updated 2022

What is ESG?

Climate related risk is a subset of environmental risk. ESG (environmental, social and governance) are the three central factors in measuring sustainability and impact on society of an investment in a company to help determine its future financial performance.

The environmental criteria look at how an organisation performs as a steward of the natural environment including greenhouse gas emissions, water usage, and waste and pollution, including both outputs and inputs.

This factsheet considers climate related risk.

What are the Most Significant Global Environmental Threats?

A survey of significant global environmental threats involving 1,000 experts and industry leaders identified 10 priority risk concerns as:

1. Failure to adapt to climate change.
2. Incurable pollution of Earth's air, water or land.
3. Antibiotic resistant bacteria.
4. Mismanagement of land and waterways as a result of deforestation, waterway diversion, mineral extraction and other environment modifying projects.
5. Mismanaged urbanisation as a result of poorly planned cities and ballooning city populations.
6. Persistence of extreme weather patterns.
7. Rising greenhouse gas emissions.
8. Irreversible biodiversity loss of species through extinction or ecosystem collapse.
9. Unprecedented geophysical destruction arising from earthquakes, volcanic activity, landslides or tsunamis of unparalleled magnitude.
10. Vulnerability to geomagnetic storms that damage or disable critical communication and navigation systems.

What is Climate Related Risk?

Climate related risk refers to the risk that the activities of an organisation might cause destruction to the surrounding natural environment and potentially wildlife in its natural habitat. It may result from climate change and could potentially impact (a) safety of the Earth and its inhabitants (b) financial stability. Consequently, the risk could potentially translate into reputation and economic consequences for organisations.

Climate variability includes variations in the climate that last longer than individual weather events.

Global warming is the long-term heating of the Earth's climate system due to human activities and caused primarily by fossil fuel burning which increases heat-trapping greenhouse gas levels in the Earth's atmosphere. The Industrial Revolution was the transition to new manufacturing processes in Europe and the United States of America between 1760–1840 and is often viewed as a climate change starting point.

Climate change refers to variations that persist for a long time period, typically decades or more. The Earth's climate has been increasingly affected by human activities causing global warming and climate change. Increased heat and drought linked to climate change have increased the risk and impact of bushfires. Reduced water supplies, lower agricultural output, insect outbreaks, rodent plagues, health impacts due to heat, and flooding and erosion in coastal areas are further examples commonly linked to climate change.

Why is Climate Related Risk Important?

McKinsey and Company describe seven characteristics that stand out about climate related risk:

Increasing – The level of climate related risk will continue to increase.

Spatial – Climate hazards manifest locally, and the direct impacts of climate related risk need to be understood in the context of geographically defined areas – there are variations between countries and within countries.

Non-stationary – As the Earth continues to warm, climate related risk is ever-changing and non-stationary. Further warming is 'locked in' for the next

decade because of physical inertia in the geophysical system. Climate science tells us that further warming and risk increase can only be stopped by achieving net-zero greenhouse gas emissions. Given the thermal inertia of the Earth system, some amount of warming will likely occur after net-zero emissions are reached.

Non-linear – Socioeconomic impacts are likely to propagate in a non-linear way as hazards reach thresholds beyond which the affected physiological, human-made or ecological systems work less well or break down and stop working altogether – this is because systems have evolved over time for historical climates.

Systemic – While direct impact from climate change is local, it can have knock-on effects across regions and sectors through interconnected socioeconomic and financial systems.

Regressive – The poorest communities and populations are typically the most vulnerable. Climate related risk creates spatial inequality as it may simultaneously benefit some regions while harming others.

Under-prepared – While companies and communities have been adapting to reduce climate risk, the pace and scale of adaptation are likely to need to significantly increase to manage rising levels of climate related risk. Adaptation is likely to result in rising costs and difficult choices including whether to invest in hardened measures against climate related risk events or relocating people and assets.

What are Some of the Issues?

Climate related risk debate continues and there are various views. According to Australian Financial Review reports, unresolved issues include:

- › No mandated standard or approach to climate related risk reporting.
- › No standardised approach to climate related risk disclosure.
- › Questionable assumptions underpinning climate related risk modelling and reporting.
- › Slow take-up among large organisations.
- › Lack of consistency across sectors.

The implications arising from these observations is that climate related risk is not receiving an appropriate level and regularity of attention from boards, audit committees, executive management or internal auditors.

The Financial Stability Board (FSB) Taskforce on Climate-related Financial Disclosures (TCFD) is seen as the global standard-setter on climate related risk, and it says:

Climate change poses both risks and opportunities for business, now and in the future. As the Earth's temperature rises, increasingly common natural

disasters are disrupting ecosystems and human health, causing unanticipated business losses, and threatening assets and infrastructure. In response, governments and private sector entities are considering a range of options for reducing global emissions, which could result in disruptive changes across economic sectors and regions in the near term.

Currently, however, investors, lenders, and insurers don't have a clear view of which companies will endure or even flourish as the environment changes, regulations evolve, new technologies emerge, and customer behavior shifts — and which companies are likely to struggle.

Without reliable climate-related financial information, financial markets cannot price climate-related risks and opportunities correctly and may potentially face a rocky transition to a low-carbon economy, with sudden value shifts and destabilising costs if industries must rapidly adjust to the new landscape.

What are Climate Related Risk Financial Reporting Implications?

There is a push in some circles for climate related risk to be included in good practice corporate governance principles. Some jurisdictions are starting to talk about mandating climate risk reporting. There are organisations now starting to recognise climate related risk in their financial statements.

In its publication 'Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/IASB Practice Statement 2', the Australian Government's Auditing and Assurance Standards Board (AUASB) says in relation to climate related risk reporting in an organisation's financial statements:

Climate-related risks and other emerging risks are currently predominantly discussed outside the financial statements, if at all. However, as set out in AASB/IASB Practice Statement 2 Making Materiality Judgements (APS/PS 2), qualitative external factors such as the industry in which the entity operates, and investor expectations may make such risks 'material' and warrant disclosures when preparing financial statements, regardless of their numerical impact.

Given investor statements on the importance of climate-related risks to their decision making, the impact of the materiality definition and APS/PS 2 is that entities can no longer treat climate-related risks as merely a matter of corporate social responsibility and may need to consider them also in the context of their financial statements.

For example, an entity in an industry likely to be impacted by climate-related risks determines that its impairment testing does not need to include a specific assumption regarding such risks. However, taking into account investor comments on the importance

of climate-related risks to their investment decisions and reasonable expectations that the entity could be impacted by such risks, applying APS/PS 2, the entity assesses that its assumptions regarding climate-related risks are material and need to be specifically disclosed, even though there is no impact on amounts recognised in the financial statements.

The Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AUASB) expect that directors, preparers and auditors will be considering APS/PS 2, when preparing and auditing financial statements for their next half and full year ends. Even though the guidance is not mandatory, it represents the AASB's best practice interpretation of materiality and entities in Australia are already being subject to lawsuits regarding lack of disclosure.

What are Questions to Ask?

Climate related risk questions to ask organisations are:

- › Does the organisation have an up-to-date climate related risk policy that reflects contemporary disclosure expectations and board requirements?
- › If the organisation has not issued a climate related risk policy, statement or report, has the governing body considered whether:
 - › It should?
 - › Whether competitors are doing so?
 - › The mood of major shareholders?
- › Do the organisation vision and values specifically reflect a commitment to establishing and maintaining leading practice climate related risk?
- › Does the board and audit committee have climate related risk as part of their agendas?
- › Does the organisation have an approved policy and framework for climate related risk that seeks to make sustainable living commonplace and includes such things as:
 - › Sustainability?
 - › Water safety?
 - › Deforestation?
 - › Use of natural resources?
 - › Waste and pollution?
 - › Greenhouse gas emissions and climate change?
- › Has the organisation formally assessed climate related risk and developed action plans to remediate identified exposures outside the organisation's defined risk appetite?
- › Do action plans have clear targets and accountabilities and include:
 - › Potential climate related risk damage to the organisation's intangible value?

- › Reputation?
- › Ability to operate?
- › Where legislated or voluntarily applied, is climate related risk in operational areas:
 - › Understood and periodically reinforced?
 - › Managed or mitigated?
 - › Appropriately reported, with clear rules established to ensure the integrity of reporting?
- › Is there climate related risk awareness training for the workforce including contractors and suppliers?
- › Are climate related risk requirements built-in to employee job descriptions and contractor contracts?
- › Is there regular dialogue with stakeholders and investors to ensure the organisation clearly understands current and evolving external expectations in relation to climate related risk?
- › Is climate related risk covered in the crisis management plan or business continuity plan?
- › Is there a media plan to deal with the media following an unforeseen climate related issue becoming prominent in the media?
- › Does the internal audit plan include appropriate coverage of climate related risk, including policy compliance and the integrity of associated internal and external reporting?

Acknowledgement

This factsheet has drawn upon information from a variety of sources which are shown below in 'useful references'.

Useful References

'The 20 Critical Questions Series – What Directors should ask about ESG,' IIA-Australia

White Paper 'The Benefits of Addressing ESG Risk', IIA-Australia

White Paper 'ESG and the Role of Internal Audit', IIA-Australia

'Climate Risk and Response: Physical Hazards and Socioeconomic Impacts', McKinsey and Company

'Climate-related and other emerging risks disclosures: assessing financial statement materiality using AASB/IASB Practice Statement 2', Australian Government Auditing and Assurance Standards Board

Australian Financial Review reports

Financial Stability Board (FSB) Taskforce on Climate-related Financial Disclosures (TCFD) - <https://www.fsb-tcfd.org/about>

World Economic Forum Global Risks Reports