acumen7

Insight

Climate Risk Reporting: Managing Risk + Creating Opportunities
What Directors should know, right now

Summary

acumen7's view, as an independent adviser to directors and senior executives, is that climate risk reporting could be viewed as yet another tedious piece of reporting or, more usefully in our view, a significant opportunity to thoroughly think through and act upon the very uncertain future. 'Official' advice is to consider a 2-degree centigrade global temperature increase scenario, without specifying any particular timescale. Who will decide what this consequent future will look like in economic, social and political terms? But significant scientific opinion, such as that of the Cambridge Centre for Climate Repair is that temperature increases may well be higher than this and require carbon sequestration from the atmosphere. In addition, our actual future is dependent upon complex interactions between politics, economics and social conditions. Our advice is that useful scenarios of the future should reflect several possible futures, and also specify possible timelines to reach those futures, all of which are internally consistent. Only then will boards be able to decide upon robust strategies and contingency plans to take advantage of possible futures. So scenarios have to be more than just scientific conjectures, they need to have economic, political and social pictures attached.

Why climate risk reporting?? The facts around, and the causes of, climate change are contentious. Partisan positions have been taken, people question the science, and the debate has become one of assertions. 'Net Zero' has entered the lexicon, but many climate scientists believe that even achieving this will not be sufficient and will require 'climate repair'. Against this, there is a pressing need (an assertion!) to prepare and take action to manage climate change, in the public realm and in business. There is a fear that only a catastrophic event will significantly change attitudes and actions.

However, in the background until recently, the Task Force on Climate-related Financial Disclosures (TFCD)[1], chaired by Michael Bloomberg, has been quietly working away on recommendations for corporate reporting of climate change risk. But now companies will almost immediately need to take action. As the Wall Street Journal reports: *"Working out who might be hit next is challenging for investors. The potential impact and costs of climate change are complex to estimate, particularly given the long time horizon and range of pathways the world might take as it tries to decarbonize. By forcing companies to work through different scenarios publicly, the TCFD reporting should bring some much-needed clarity to risks outside of obvious problem sectors like oil and gas. It should also shed light on climate leaders and laggards within sectors."*

[1] https://www.fsb-tcfd.org/?utm_medium=Adwords&utm_campaign=TCFD&utm_source=pdsrch&utm_content=tcfd&tactic=369851&gclid=Cj0KCQiAk53-BRD0ARIsAJuNhpvpQjxGYrCsmupeloDmOXXTMhoyERCpOeG8D9nmY0NUu6LfEdLsGC4aAmvPEALw_wcB

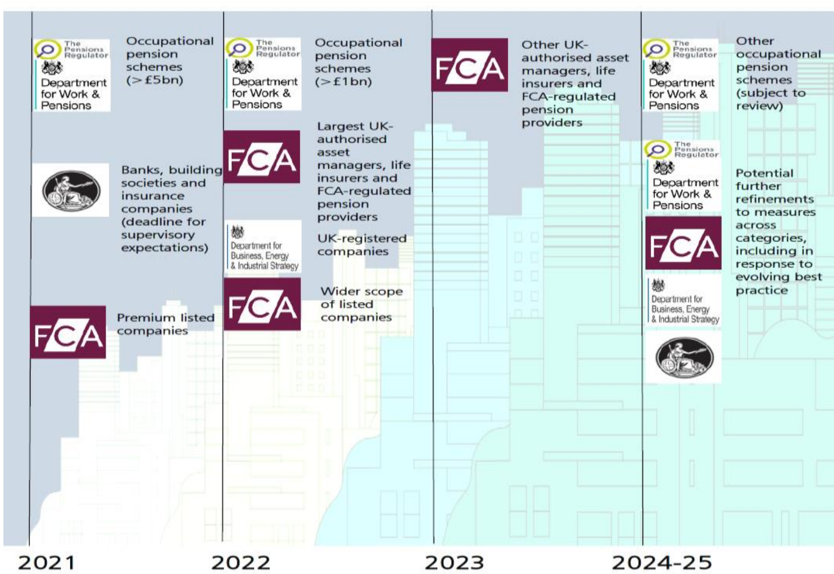
The UK Treasury is promoting this approach in preparation for COP26
(Along with BEIS, FCA, DWP, and the Pensions Regulator)

The Roadmap, published in November 2020 by HM Treasury, sets out an indicative path towards mandatory climate-related disclosures across the UK economy aligned with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD). The document says:
"The ambitious but proportionate strategy presented in the Roadmap will help ensure that the right information on climate-related risks and opportunities is available across the investment chain – from companies in the real economy, to financial services firms, to end-investors."

The Roadmap is shown below and highlights the proposed rapid introduction of these measures. For example, banks, building societies, insurance companies and 'premium' listed companies are expected to comply in 2021, with other listed companies expected to comply in 2022.

Figure 1. Roadmap towards mandatory TCFD-aligned disclosures

Timeline of planned or potential regulatory actions or legislative measures



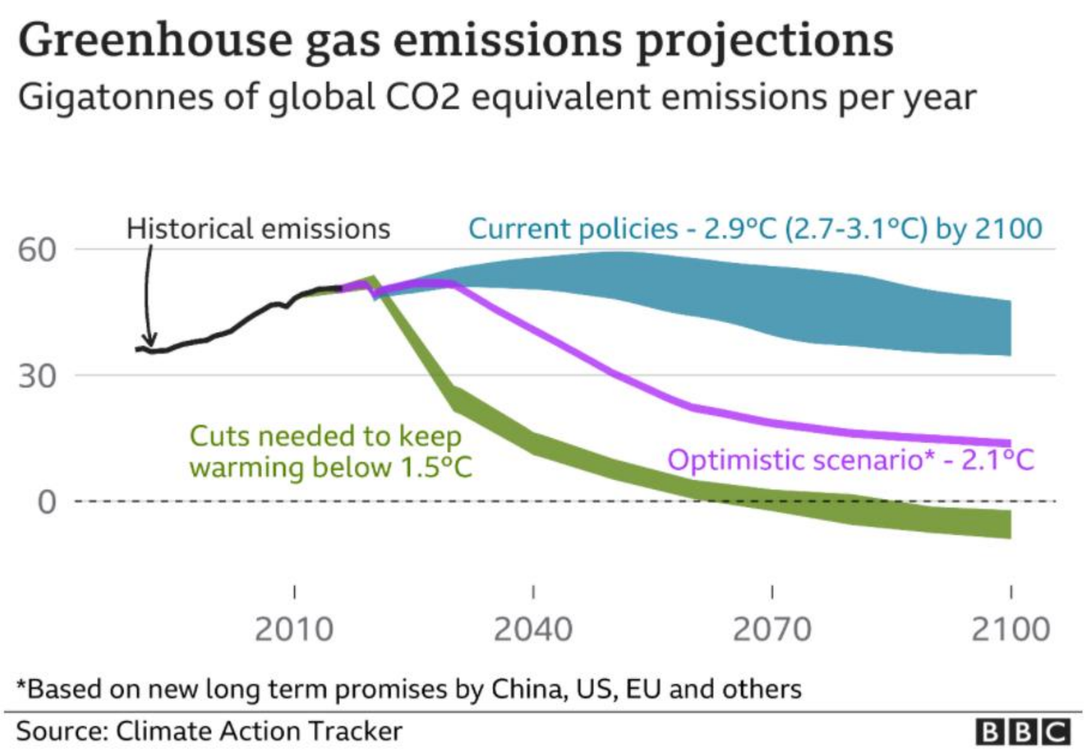
The Roadmap illustrates rising coverage of disclosures over the next three years…

1.20 Figure 2 illustrates how the coverage of supervisory expectations, disclosure rules or legislative requirements is expected to rise over the coming years. The bars denote the percentage coverage of regulatory disclosure rules or legislation (pink) or the PRA's supervisory expectations (blue) at each point in the timeline. Where these measures are subject to the outcome of current or

Climate-Related Scenarios – Issue or Opportunity?

According to the Recommendations of the Task Force on Climate-related Financial Disclosures document[2], *"One of the Task Force's key recommended disclosures focuses on the resilience of an organization's strategy, taking into consideration different climate-related scenarios, including a 2° Celsius or lower scenario. An organization's disclosure of how its strategies might change to address potential climate-related risks and opportunities is a key step to better understanding the potential implications of climate change on the organization. The Task Force recognizes the use of scenarios in assessing climate-related issues and their potential financial implications is relatively recent and practices will evolve over time, but believes such analysis is important for improving the disclosure of decision-useful, climate-related financial information."*

The Task Force recommends using a +2 degree C scenario, which in itself *may* well be sensible. However, there is a wide range of possible outcomes (for example, a recent McKinsey publication reports *"scientists predict that the global average temperature may increase by 2.3 degrees Celsius by 2050, relative to the preindustrial average", and see below published in November 2020*) and the route to each is dependent upon a range of factors, many of which are political (e.g. attitudes to climate change in the USA, China…), some of which are scientific (e.g. will economically viable processes to capture carbon from the atmosphere be discovered and developed?). Each of these possible futures will feature different economic, political and social conditions, and the route to each will be different.



[2] https://www.fsb-tcfd.org/publications/

Some expert groups (for example, the Cambridge Centre for Climate Repair, led by Sir David King, the former Government Chief Scientific Adviser) suggest that even 'Net Zero' by 2050 is insufficient to control warming, and that without carbon capture and storage, the climate is destined for runaway temperature increase. It is thus very important for organisations in their analysis and reporting to investors to go deeper than looking at, for example, just the effect of a sea level rise of X meters and set their strategies against a range of possible climate/economic/political/social futures. Climate change should no longer be a 'strategic surprise' to us, but the impact of climate change will certainly produce some 'tactical shocks', for which organisations should be prepared with appropriate contingency plans.

The scenario approach is not new but is little properly used. Shell is a very early exponent[3]and in the US, the Coast Guard[4] and branches of the Military as well as commercial and not-for-profit organisations have used the Futures Strategy Group (https://www.futuresstrategygroup.com/) to organise and run their scenario strategy processes (see recent Harvard Business Review article 'Learning from the Future'). As Director of Strategy for Deloitte, I used this firm to help run our global strategy process, and can affirm that the outcome was highly successful, enabling our senior leadership team to visualize and plan for significant future events and contingencies, and bringing about committed changes in the global organisation.

Many people and organisations will have used the idea of scenarios in their work, for example, in the insurance industry, where scenarios are often used in risk management to assess particular risks. However, in the real world, the future will be a product of interwoven and contingent events. What we suggest here in this Insight though, is that climate change and its effects, and hence risk (and opportunity), is highly complex, and must be approached in a more structured and wide ranging way, drawing upon new expertise.

How to respond in practice? It is very difficult to envisage what a future with climate change looks and feels like. Often the issue with doing so is with projecting from today ('today weighting'). The solution is to use scenarios to 'live in' a defined future. Well run insurance companies are experienced in using the concept of scenarios for risk management purposes. However, the time scale, complexity and interconnection of possible future events demands a different approach to the *generation* and strategic *use* of scenarios.

Scenarios, or as we could call them, *stories*, avoid the issues of assertion, by saying "What if …this particular driver/force/response unfolds, what does the world look like/feel like?" To respond to the threat (and opportunities) of climate change requires a strategic response which builds upon a risk management response – senior management needs to be involved and committed to a sound process, otherwise change is difficult if not impossible. It is our experience that the process itself of generating useful scenarios is part of that strategic response, and this then enables superior strategic decisions to be formulated and *acted* upon.

[3] https://www.shell.com/energy-and-innovation/the-energy-future/scenarios.html

[4] https://www.uscg.mil/Portals/0/Strategy/Report%20Evergreen%20II%20Project.pdf

In the view of the Futures Strategy Group, it is essential to use typically four or more stories/scenarios to avoid the users from describing a top/middle/bottom view – the stories are defined to describe the boundaries of possible futures, and are to be used to generate logical responses and contingency plans. 'Follow the money' is often a good strategy, and the underpinning of the stories should come from robust and expert analysis of the consequences of the events outlined in the story.

How could this work? These stories would be possible histories of the last 30 years….For example: "It is 2050, and we look back at how we got here…..". Each story is an internally consistent political/economic/scientific/financial record of the key forces driving that past, and the impact those forces had. The stories are literally that, stories, because they are not predictions, but projections based upon differing unfurling of the key forces. No one story is 'the most likely' since all four stories are possible and it is up to the reader to decide what they would do strategically in *each* story. Out of this will come robust strategies which work well in all or most of the stories, and contingency plans to prepare for events or outcomes which are confined to only one or possibly two of the stories.

Conclusions

With this in mind, here are some critical questions directors and executives should ask:

- What are appropriate scenarios for my business?
- What timescales should we be looking at?
- What will provide maximum value for my investors from this reporting? And what do they say they require?
- What should be our process for assessing, managing and reporting risks **and** opportunities?
- Who should be involved?
- When should we do this?

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