How Climate Risks are Impacting Directors in their various Board Roles:

A view from Australia

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Summary

From a fundamental governance pers-pective, climate risk can threaten business models in the extractives sector, and should be front and centre of board discussion. Individual directors need to show due diligence in relation to changes in the legal environment and be mindful of how this risk impacts their various board roles.

Introduction

Good governance requires effective oversight of risks which is the role of board directors, and governance and risk committees of those boards. Importantly, risks, whether emerging or long standing, provide an opportunity for organisations to differentiate themselves from their competitors if action is taken ex-peditiously to get in front of the changes that arise. How businesses in the resources and extractives sector approach risk governance and management is important as it impacts upon supplier relationships through to how they are perceived in the market, through to relationships with customers and society more broadly.

From a fundamental governance pers-pective, given that climate risk can threaten business models in the extractives sector, there should be sufficient concern by directors of the risk of insolvency and other financial shocks to their business to warrant further exploration and a demonstration of additional vigilance in this aspect of corporate governance.

Figure 1: The main elements of the roles of a Non-Executive Director

One of the roles of boards is the development of board-level policies for an organisation (Figure 1). For example, boards must consider the risks posed by climate change on operations and strategy, and any risk policy, and the company's risk appetite statement. Boards should also be turning their minds to the direct and increasingly indirect impacts of climate change on their businesses such as increasing energy costs and energy security and ensuring their operations have measures in place to counter these impacts. A further consideration around policy is how company boards posture themselves in relation to government positioning on climate action.

There is growing consensus in management circles that one of the major challenges of our time including climate change and a call for questioning Business As Usual (BAU) corporate

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governance models and practices. The chaotic political battles and ongoing changes in climate policies are making Australia in particular, a country at risk of missing its overall goals and ambitions for reducing carbon emissions. In Australia the business community, the capital market, and investors are all in urgent need for climate policy certainty at the state and federal levels to ensure the positive effect of carbon performance on financial returns over the long terms. Directors therefore should remain alert to the need for driving their businesses to improve the way in which they govern for climate risks, and harness whatever levers they are able to, to demonstrate leadership in climate risk mitigation and seizing the opportunities it presents. Millennial aged investors and consumers are taking action with their feet on climate-related issues and are already changing the flow of capital. This will have profound impacts on allocation of capital and both the emergence of new sectors and destruction (or stranding) of incumbent technologies, industries and their assets.

Climate Issues and Emerging Legal Risk

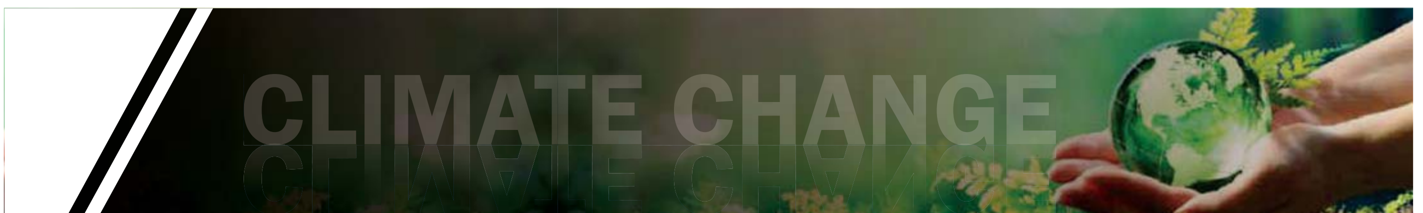
Carbon border tariffs have been considered as challenges for Australian businesses for some time , but are now likely to come into effect in the EU. Apart from this challenge to our export industries, there are a range of laws that directly and indirectly impact on corporations. Directors and executives (officers) of a company should be aware of consequences of non-compliance as these usually lead to direct personal liability. Litigation in this area has increase dramatically in recent years. Many operational aspects of an extractives company will be influenced by changes in laws such as contracts. Individual directors need to be able to demonstrate that they are showing due diligence in relation to changes in the legal environment.

This is an evolving area of corporate regulation and risk and governance professionals can expect to see changes in the short- to mid-term. How regulators respond to the landscape of emerging risks is currently uncertain. In Australia, the prudential regulator and corporate regulator are increasingly tightening the controls on banks for lending and introducing new advisory position papers on emerging risks including climate change. This is a signal that further regulation impacting upon governance and risk is likely in Australia.

In addition to the strategic issues regarding climate change, there are emerging legal risks associated with this risk. For example, The Hutley Opinion ("Climate Change and Directors Duties"), a significant legal opinion that was published by highly respected lawyers in Australia in recent years, has been an important step for clarifying responsibilities of directors and officers in Australia. Directors will be liable for failing to ask about the climate risks impacting their organisations. APRA, Australia's prudential regulator, has also come out with a position and has indicated that listed companies would be prudent to comply with the TCFD recommendations regarding climate risk disclosures. Over the past 3-4 years, corporate Australia has seen climate risk go from a niche issue to now being incorporated into guidelines referenced by our financial regulators. Climate-related risks present an upside too. Specific to climate-related risks, the following four examples which reflect changes that have occurred which are relevant in company director setting in Australia, and many of these examples are manifestations of what has transpired from the experience of Europe as it has systematically dealt with the issues of climate risk governance and its critical linkage to financial stability.

Financial and corporate regulators are turning their minds to climate related risks, and current and position papers are likely to come into law in the near future as is evident from the European experience. For example, how the rule of law is changing in relation to climate risk and how these impact on the roles of directors. They don't just apply to the extractive industry risks but have broad application to corporate climate change risks and how directors should prepare for these. Table 1 explores the climate risks as they align with each of the main roles of board directors.

There are four examples described here that illustrate how emerging thought leadership, regulatory notes and white papers and shifting positions from the director industry body are shaping the discourse at the board level, and potentially will become a requirement for doing business in Australia. These examples, which were introduced at the forum, are from organisations that regulate and oversee corporations in Australia, illustrate that climate related risks must now be dealt with as any other risk faced by an organisation:



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Governance Role	Description and Implication for Directors
Finance	The TCFD and AASB set out how financial business models can be assessed for climate risks and how to disclose this risk to the marketplace. The finance sector is driving the corporate and regulatory interest and reform in the disclosure of climate related risk.
Board role and being a Director	Boards set the "tone at the top" and provide the enabling environment for climate risk discussions. The approach to climate risk and opportunities will be impacted by the values of the board. Climate risk should be included in engagement discussions with key stakeholders. The skills matrix of a board should reflect its capacity to oversee the climate risks relevant to its business. Depending on extent of risk exposure, climate risk and opportunity evaluation must be part of decision making at the board level.
Decision Making	Timeliness of decisions should reflect the degree of climate risks as climate risks are already crystallising in most sectors. Effective decision making at the board level should include impacts of climate risks where this is material. Climate change can also impact upon the certainty associated with key organisational decisions.
Director's duties	Diligence and fidelity are the cornerstones of director's duties as set out under the Corporations Act (2001) in an Australian context and these apply to climate risks and their disclosure. Conflicts of interest may impair the judgement of directors in making effective decisions that involve climate change and the causes of it. Climate change can impact the long term value of an organisation and must be recognised as such. Climate risks can impact on the viability of a business and therefore its ability to remain solvent.
Legal environment	There are a range of laws that directly and indirectly impact on climate risks. Directors and executives (officers) of the company should be aware of consequences of non-compliance as these usually lead to direct personal liability. Contracts will be impacted to varying extent by climate-related risk and opportunities and can impact long term viability of an organisation. Individual directors need to be able to demonstrate that they are showing due diligence in relation to legal implications from climate risks.
Risks	Climate risks are foreseeable. The fact that the impacts are "foreseeable" is now settled within the legal profession. Risk appetite, risk policies and frameworks should reflect climate risks. Climate risk should be considered as an emerging risk if it hasn't already crystallised in an organisation or an organisation's sector. An assessment should be made as to how climate risk is likely to impact value (of the company and its offering).
Strategy	Leadership must acknowledge climate risk and if executives don't then boards should ask if they are the right people to be leading the business at this time. Climate risk should be factored into the forces that impact upon and shape an organisation's strategy. Climate risks should be considered in the strategic planning process.

Table 1. Roles and Responsibilities of Directors in relation to Emerging Climate Risks

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1. The Australian Accounting Standards Board (AASB) and the Auditing Assurance Standards Board (AuASB)
2. The ASX (Australian Stock Exchange) Corporate Governance Principles
3. The Australian Prudential Regulation Authority (APRA), the Reserve Bank of Australia (RBA) and Australian Securities and Investment Commission (ASIC)
4. The Australian Institute of Company Director's (AICD)

Example 1.

The Australian Accounting Standards Board (AASB) and the Auditing Assurance Standards Board (AuASB) updated its financial reporting requirements, expanding them to capture material financial impacts of climate risks in the financial reports of entities reporting under its jurisdiction. These are voluntary guidelines that provide the financial reporting profession advice as to how to consider material financial impacts from climate change on an entity's financials. These have adopted the principles set out in standards that are now appearing internationally including the Task Force for Climate-related Financial Disclosures or TCFD, as well as the initiatives of investor groups. While voluntary in Australia, internationally the TCFD recommendations are becoming integrated into law. Many companies are now reporting against them including those in the extractives sector. The model of the TCFD is set out in Figure 2.

Example 2.

The ASX Corporate Governance Principles 4th Edition (published in February 2019). These are guidelines that Australian Stock Exchange (ASX) listed entities are required to comply to.

These principles state:

"One of the key roles of the board of a listed entity is to monitor the adequacy of the entity's risk management framework and satisfy itself that the entity is operating with due regard to the

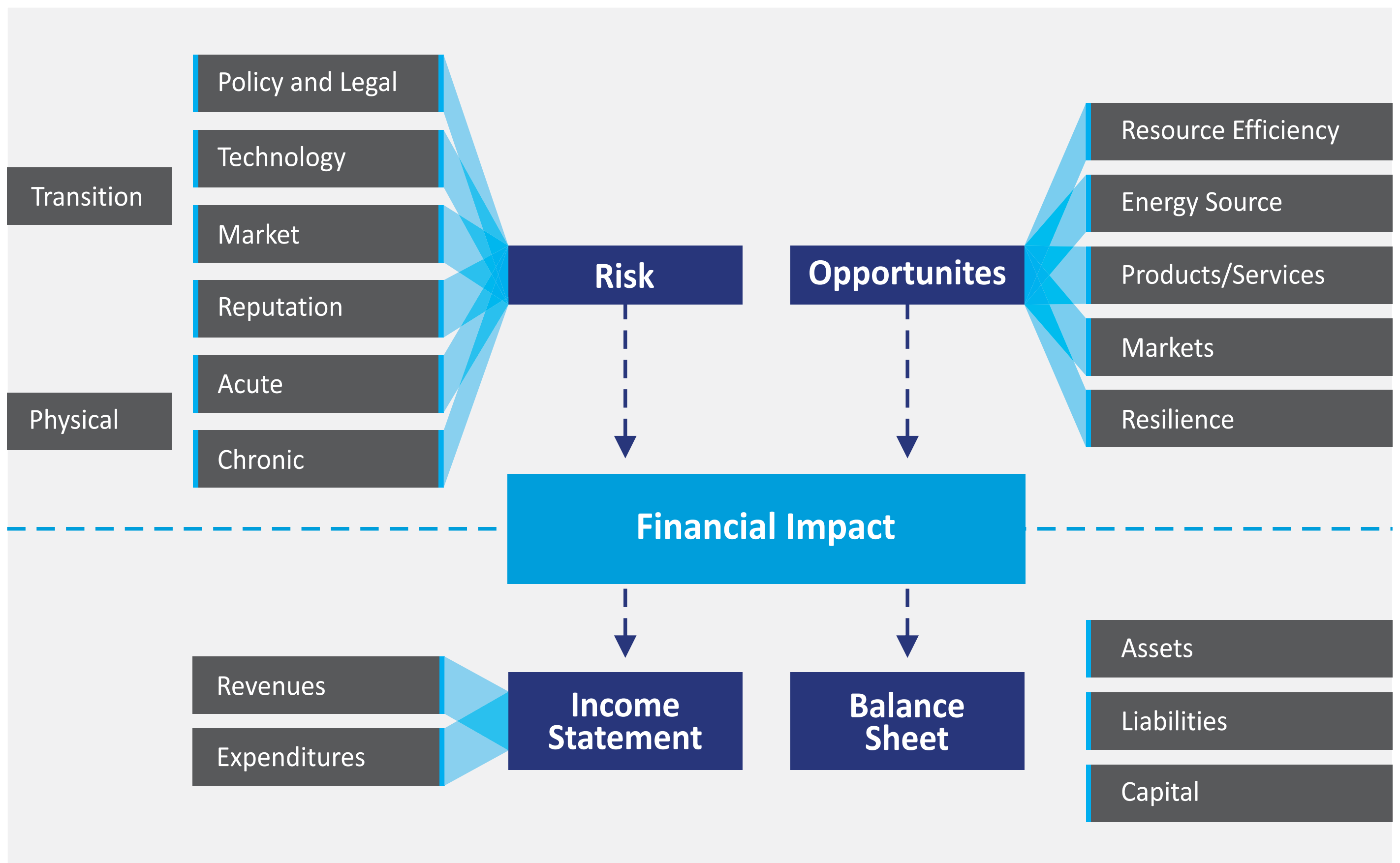

Figure 2.

*An overview of the TCFD model. Many aspects of the model show how climate-related impacts can directly or directly impact the financial business models of resources and extractive companies (source **www.tcfd.org**)*

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risk appetite set by the board. This includes satisfying itself that the risk management framework deals adequately with contemporary and emerging risks such as conduct risk, digital disruption, cyber-security, privacy and data breaches, sustainability and climate change. One particular source of environmental risk relates to climate change. This includes: 1. risks related to the transition to a lower-carbon economy, including policy and legal risks, technology risk, market risk and reputation risk; and 2. physical risks, such as changes in water availability, sourcing, and quality; food security; and extreme temperature changes affecting an organisation's premises, operations, supply chains, transport needs, and employee safety".

Many listed entities will be exposed to these types of risks, even where they are not directly involved in mining or consuming fossil fuels. The Council would encourage entities to consider whether they have a material exposure to climate change risk by reference to the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures ("TCFD") and, if they do, to consider making the disclosures recommended by the TCFD.

It is important to note that the Council takes an "If not, why not approach" to reporting disclosures on all of its reporting requirements.

Example 3.

The Australian Prudential Regulation Authority (APRA), the Reserve Bank of Australia (RBA) and Australian Securities and Investment Commission (ASIC) have all released statements and positions on climate related risks. The following quote from RBA is important. It shows an expectation that companies should look at modelling different scenarios and time horizons to explore potential implications, not just 'document static metrics'. This implies sophisticated analysis of climate risks.

"Financial entities should consider their need to be able to model the potential impact of CCR [Climate Change Resilience] risks under different scenarios and over different time horizons, beyond mere documentation of static metrics. ..... it is incumbent on both APRA and its regulated entities to consider CCR risks, and put in place actions to mitigate those that could have a significant financial impact if left unaddressed".

Example 4.

The Australian Institute of Company Director's (AICD) Updates for the past 3 years have highlighted climate-related risks as material matters boards need to consider routinely. Coupled with energy policy, and social license issues, climate-risk is now front and centre as an issue for board directors to consider. It is worth pointing out that the AICD is a conservative organisation and does not typically raise risk issues unless they have considered them to be real and critical for their members.

What this governance area means for the resources and extractive industries in terms of its significance, is that climate risks issues, and related regulatory pressure, will only increase over time. This issue could affect the extractive industries, both in the short and long terms, and operations and supply chain partners will be increasingly impacted in a wide range of ways. One of these will ultimately be in gaining access to new ore reserves (or not), and shifting away from carbon intensive assets and operations. The issue could be addressed, both in the short and long terms, through modelling of vulnerabilities in the supply chain as well as examining the risks particular to a particular business' financial and operating model. This issue is already impacting the extractive industries, through slowing (and in some cases eliminating) the extraction of certain minerals eg thermal coal, which is a major contributor to climate change. The risk is being addressed, both in the short and long terms, by businesses in the sector decarbonising their ore asset portfolio, as well as their business operations (e.g. by diversifying energy inputs), and offsetting any residual carbon emissions. Directors need to understand what questions that they should be asking in relation to climate change. The overarching questions in relation to the board, non-executive directors and risk are:

- "Does our organisation's approach to risk management demonstrate care and due diligence for the type and size of organisation that we as directors are governing?" and
- "Does our approach to risk management create value or is it a tick and flick exercise?"

Lastly, **some of the questions that directors should consider asking of their organisations in relation to climate change and governance and risk issues** are:

- Are we disclosing our climate-risks in a transparent and credible manner? What standard or recognised approach are we following?
- What are our climate-related risks and opportunities and have we quantified these? What vulnerabilities are we exposed to across our value chain?
- In what ways are we protecting our assets from becoming stranded as the market transitions to a low-carbon economy?
- What is our business' pathway to net zero carbon emissions?
- Do we know how our organisation could be impacted under various future legal, market and other scenarios?
- In what way are we protecting our balance sheet from stranded assets?
- What contingency strategies do we have to protect our revenues in the event our supply chain is impacted negatively by climate risks?

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- What do the two and 10 year outlooks say about how climate risks will impact our business model and operating model? Does the business' strategy consider the projected outlook(s) or scenarios?
- How prepared are we as an organisation in a dramatically increased regulatory environment?
- Do we as an organisation know our pathway to zero emissions? Have we stressed tested plausible pathways?

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