Investor Group on Climate Change

IGCC POLICY UPDATE

November 2019

CLIMATE RISK AND FIDUCIARY DUTIES

Summary

- Climate change is a systemic threat to the financial system and presents a material risk to the investment returns of long-term asset owners and their underlying superannuation members. Central banks and national financial regulators are increasingly warning of the financial risks of climate change.
- Investors have a clear legal obligation to manage climate risks. In addition, financial regulators around the world are now requiring a proactive response from investors and companies to manage climate related financial risks in order to ensure financial stability.
- Institutional investors are responding to climate risks in a range of ways. They are:

  - integrating climate change considerations into investment practice
  - increasing engagement with the world's largest companies to implement business plans to thrive in a resilient, net zero emissions economy
  - engaging with policymakers to deliver credible, investable and durable policy frameworks.

About Us

The Investor Group on Climate Change (IGCC) is a collaboration of Australian and New Zealand investors focused on the impact that climate change has on the financial value of investments. The IGCC represents institutional investors with total funds under management of over $2 trillion, and others in the investment community interested in the impact of climate change. IGCC members cover over 7.5 million people in Australia and New Zealand.

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CLIMATE RISK AND FIDUCIARY DUTIES

Introduction

Australian superannuation funds currently invest more than $2.9 trillion in assets (as at June 2019) on behalf of their members. As trustees of members' retirement savings, super funds have a legal obligation to act in the best interest of their members and to grow their retirement funds responsibly. This is their fiduciary duty.

Climate change is a systemic risk

Climate change is recognised as a systemic threat to the financial system. The economic impacts of climate change present material risks to the investment returns of long-term asset owners and their underlying members. Ultimately, institutional investors invest across the economy for the long-term and are exposed to the growing impact of climate change on the companies, industries, property and infrastructure assets they own.

As the Reserve Bank of Australia stated in October 2019:

> *"Climate change is exposing financial institutions and the financial system more broadly to risks that will rise over time, if not addressed. According to the Intergovernmental Panel on Climate Change (IPCC), it will take significant effort to limit global warming to 1.5°C above pre-industrial levels, as targeted in the Paris Agreement. Even if targets are met, this level of warming is likely to be accompanied by rising sea levels and an increase in the frequency and intensity of extreme weather (including storms, heatwaves and droughts). Some of these outcomes are already apparent. These changes will create both financial and macroeconomic risks."*

In addition to the financial and economic impacts of climate change, investors are also exposed to regulatory shifts, technology disruption and changes in market demand for carbon intensive goods and services like fossil fuels – all of which could diminish the value of investments.

The potential implications of a disorderly transition from fossil fuels to clean energy sources also presents significant risks. Failure to manage an orderly transition could increase electricity prices and undermine the reliability of the system with knock on effects to households and the economy more broadly.

CLIMATE RISK AND FIDUCIARY DUTIES

INVESTORS HAVE A CLEAR LEGAL OBLIGATION TO MANAGE CLIMATE RISKS

Recently published legal opinions on company and superannuation trustee directors' conclude that directors not only can but must consider climate risk (Table 1).

Table 1: Summary of legal opinions on director duties and climate risks

Corporations Act[2]	**Superannuation Industry (Supervision) Act**[3]
• 'Climate change risks' are capable of representing risks or harm to the interests of Australian companies, which would be regarded by a Court as being foreseeable at the present time. • 'Climate change risks' may be relevant to a director's duty of care and diligence to the extent that those risks intersect with the interests of the company, for example in so far as they present corporate opportunity or foreseeable risks to the company or its business model. • '...company directors certainly can, and in some cases should be considering the impact on their business of 'climate change risks'. • Directors who fail to consider 'climate change risks' now could be found liable for breaching their duty of care and diligence in the future.'	• 'Climate change risks can and should be considered by trustee directors to the extent that those risks intersect with the financial interests of a beneficiary of a registrable superannuation entity...' • 'Trustee directors should source, consider and weigh relevant information relating to climate change risk and record their decision making processes, including any considerations of climate change risks...' • '... it is incumbent upon a trustee director, in an appropriate case, to consider the climate change risk in order to satisfy the requirements at s 52A(2)(b) in relation to due care, skill and diligence, s 52A(2)(c) in relation to the best interests of beneficiaries and at s 52A(2)(f) in relation to ensuring a corporate trustee carries out the 2 52 covenants'.

CLIMATE RISK AND FIDUCIARY DUTIES

FINANCIAL REGULATORS EXPECT INVESTORS TO MANAGE CLIMATE-RELATED RISKS

The timeline below outlines the signals that scientists, governments and financial regulators have been sending to financial markets on climate change since 1990. It is clear that the scientific consensus on climate change has been robust and growing in confidence over the last 30 years. Governments around the world have also been progressively building the international architecture to limit global warming over the same period and implementing policies to reduce national emissions. This culminated in the Paris Agreement in 2015, where governments agreed to ratchet up action over time to achieve net zero emissions.

Critically, over the last five years, global financial institutions, central banks and national financial regulators have been increasingly warning of the financial risks of climate change. They are now requiring a proactive response from investors and companies to manage climate related financial risks in order to ensure financial stability. The actions of Australian regulatory bodies are outlined in Table 2.

Central to this has been the development of the industry-led Taskforce on Climate-related Financial Disclosures (TCFD) recommendations. The TCFD was developed by the G20's Financial Stability Board and focuses on the public disclosure by companies and financial institutions of climate related financial risks.

This is important because investors who are managing financial risk for the long-term need data and information to manage and price climate risks across their portfolios. Regulators also need to have good visibility of the system-wide implications of decarbonisation and climate change itself. The community is increasingly engaging with superannuation funds to better understand climate change risk exposures in their super. Effective climate risk disclosure is the foundation of good risk management for all of these stakeholders.

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Table 2: Regulatory action on climate related risks in Australia

	Public statements on climate risk	Updated guidance	Actions and responses from regulator/entity
Australian Prudential Regulation Authority (APRA)	Climate risk mentioned in several speeches [4, 5, 6] Climate change survey results released in information paper[7]	Encouraged entities to move from gaining awareness of financial risks to taking action to mitigate them APRA will increase its scrutiny of banks, insurers and superannuation trustees	Enhanced supervisory action including APRA's climate change survey Climate risk working group under Council of Financial Regulators Peer agency cooperation internationally
Australian Securities and Investments Commission (ASIC)	Climate risk mentioned in several speeches and reports	Focussed on corporate governance and disclosure	Monitoring adoption of TCFD disclosure across ASX 300 Review of regulatory guidance[10] Climate risk working group under Council of Financial Regulators Peer agency cooperation internationally
Reserve Bank of Australia (RBA)	Speech on climate change and the economy[11]	Supports TCFD as key framework for disclosures Supported APRA and ASIC's guidance	Climate change included in Financial Stability Review[12] Climate risk working group under Council of Financial Regulators Peer agency cooperation internationally
ASX	Climate risks discussed in the revised Corporate Governance Guidelines		Amended guidelines and specifically highlighted climate risk management and disclosure in line with the TCFD[14]

CLIMATE RISK AND FIDUCIARY DUTIES

HOW INVESTORS ARE RESPONDING TO CLIMATE-RELATED FINANCIAL RISKS?

Globally, institutional investors are responding to potential physical and transition risk exposures from climate change in a range of ways:

1. Investment practice: Integrating climate change considerations into asset allocation, investment mandates, performance reporting and portfolio analysis; making investments in low carbon and climate resilient portfolios, funds and assets; and phasing out investments in thermal coal.

2. Corporate engagement: Increasing engagement with the world's largest companies to secure commitments from boards and senior management to disclose their climate-related risks, take action to reduce emissions and implement business plans to thrive in a resilient, net zero emissions economy.

3. Public policy engagement: Government policy provides the signals and incentives that direct the flow of capital across the global economy. Long-term investors are engaging with policymakers as a necessary extension of their responsibilities and duties to deliver strong returns for their members. Credible, investable and durable policy frameworks put in place today can support strong investor and super fund holders' returns into the future.

Table 3: Timeline of market and regulatory signals to long-term investors on climate

	Regulatory and market signal
1990	UN Intergovernmental Panel on Climate Change (IPCC) concludes that the climate is changing and future global warming is “certain”
1992	Governments sign the UN Framework Convention on Climate Change (UNFCCC) and agree to limit “dangerous” climate change
1995	IPCC conclude that the “balance of evidence” suggests human impacts are observable in recent climate change
1996	EU ministers agree world should limit warming to 2°C
1997	Governments sign the Kyoto Protocol. Developed countries agree legally binding 2010 emissions targets
2001	IPCC conclude that it is “likely” that human impacts are observable in recent increases in global temperature
2005	Investor Group on Climate Change established by ten founding investors to better understand the investment implications of climate change
2006	Stern Review on the economics of climate change concludes the benefits of strong and early action far outweigh the economic costs of not acting
2007	IPCC concludes increase in global temperatures is “very likely” due to human activity
	Governments launch process on new global climate change agreement for action after 2012
	Garnaut Review Final Report to federal and state governments released. Recommends medium to long-term climate change policies to improve the prospect of sustainable economic growth
2008	All major emitters begin announcing 2020 emissions targets in advance of upcoming of Copenhagen meeting
2009	Copenhagen Accord finalised, including an agreement to limit global warming to below 2°C
2010	Countries enshire the below 2°C target and 2020 emissions goals under UNFCCC
2011	IPCC concludes “human influence on the climate system is clear” is having widespread impacts on human and natural systems.
	Governments launch negotiations for post 2020 global climate agreement
2012	World Bank concludes 4°C warming must be avoided or climate change will set back decades of economic development
	The China Banking Regulatory Commission issues Green Credit Guidelines for banks, to better capture ESG related risks and opportunities
	The Japan Ministry of the Environment produce the Principles for Financial Action towards a Sustainable Society
2014	Major emitters begin announcing new 2025 and 2030 emissions targets in advance of upcoming of Paris meeting
2015	In response to concerns raised by G20 Finance Ministers on climate risks the Taskforce on Climate-related Financial Disclosures (TCFD) is established by the Financial Stability Board.
	Governor of the Bank of England delivers groundbreaking speech on climate risk and financial stability to Lloyd's of London
	The Bank of England Prudential Regulatory Authority issues its report titled The Impact of Climate Change on the UK Insurance Sector
	European Systemic Risk Board publishes assessment of systemic financial risks from the transition to a low-carbon economy
	Special scientific report for the UNFCCC concludes 2°C is no longer a safe ‘guardrail’ for global action on climate change
	French government requires investors to disclose how they factor carbon-related risks into their investment policies (Article 173 in the Energy Transition Law)

	196 countries sign the UNFCCC's Paris Agreement. Strengthens global objective to limit warming to 1.5°C to "well below" 2°C and establishes goal to achieve net zero emissions
	China's central bank launches a report that sets out in specific and practical terms an ambitious agenda of how China can green its rapidly developing financial and capital markets
2016	Senate Economics References Committee Inquiry finds the disclosure of material climate-change risks is necessary to ensure investors are sufficiently informed of these risks, and to incentivise companies to manage them
	World Economic Forum issues its Global Risk Report listing climate change related risks as 4 of the top 10 global risks over the next 10 years
	Governor of the Bank of England outlines the financial stability risks posed by climate change, and how building new markets in climate transition and green finance could help resolve these risks
	European Commission establishes a High-Level Expert Group (HLEG) on Sustainable Finance to help meet Paris Agreement goals
	The 2016 Hutley opinion, commissioned by the Centre for Policy Development and the Future Business Council, finds that climate related physical and transition risks can be seen as 'foreseeable' risks, and that directors who do not properly manage climate risk may be held liable for breaching their legal duty of due care and diligence.
2017	Geoff Summerhayes, Executive Board Member of APRA, gives a speech to the Insurance Council of Australia Annual Forum stating: "The [Paris] agreement provides an unmistakable signal about the future direction of policy and the adjustments that companies, markets and economies will need to make.....[it] provides a very reliable signal that policy and regulatory efforts will intensify."
	Bank of England outlines climate related financial risks which impact upon the Bank's objectives
	The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) is established to strengthen the global response required limit warming to well below 2°C and to enhance the role of the financial system managing climate risks and delivering sustainable development. Initial founders include central banks and regulators from Mexico, England, France, the Netherlands, Germany, Sweden, Singapore and China
	The International Monetary Fund (IMF) warns that climate change will have adverse consequences macroeconomic impacts, particularly in low-income countries
	Final recommendations of the TCFD published
	IPCC publishes special report on limiting warming to 1.5°C. It concludes there are clear benefits to people and natural ecosystems in limiting global warming to 1.5°C and achieving this will require rapid, far-reaching and unprecedented changes in all aspects of society
2018	John Price, Commissioner, ASIC, delivers address stating: "...in our view, the [Hutley] opinion appears legally sound and is reflective of our understanding of the position under the prevailing case law in Australia in so far as directors' duties are concerned......the Hutley opinion highlights and reinforces the need for directors to adopt a probative and proactive approach in assembling the information reasonably required to inform their decision making in this area."
	Australian Accounting Standards Board (AASB) and Auditing and Assurance Standards Board (AASB) release joint guidance in integration of material climate-related assumptions into financial statement accounting estimates. Puts climate assumptions squarely within the remit of external audit review
	RBA joins NGFS Other new members include central banks and regulators from Finland, Luxembourg, Japan, Belgium, Malaysia, Portugal, Norway, and New Zealand
	European Commission adopts the action plan on sustainable finance to help deliver on the Paris Agreement. Amongst other items, the plan proposes requirements on institutional investors to disclose how they integrate climate risk into their decision making

	Reserve Bank of New Zealand releases Climate Change Strategy. Reports on the impact of climate change on New Zealand's financial system
2019	Additional regulators join NGFS including from Switzerland, Italy, Canada, Greece, Thailand, Hungary, Ireland, Denmark and Colombia
	ASX Corporate Governance Principles and Recommendations set out commentary regarding environmental disclosure and, for the first time, provided explicit guidance on climate change risk
	Guy Debelle, Deputy Governor of the RBA joins APRA, ASIC and the ASX in considering climate change risk through an economic lens and stressing the need for businesses, including those in the financial sector, to implement the recommendations of the TCFD. Calls climate change a "first order economic risk" for the Australian economy
	UK's Prudential Regulation Authority publishes climate change scenarios in its biennial insurance company stress test. Scenarios explore the impacts to both firms' liabilities and investments stemming from physical and transition climate risks
	NGFS publishes first technical report on climate-related risks: "Understanding how climate change impacts the macroeconomy and the financial system is a necessary first step in central banks and supervisors judging the relevance of climate change to their mandates."
	New members including United Arab Emirates, Malta, Hong Kong and South Africa
	UK Government sets expectations that all listed companies and large asset owners will disclose in line with the TCFD recommendations by 2022
	European Commission publishes guidelines on how EU companies and financial institutions should disclose climate-related financial risks
	Canada's Expert Panel on Sustainable Finance sets out road map to mainstream sustainable and climate-related finance in Canada
	Hong Kong Stock Exchange consultation to strengthen ESG Reporting Requirements for Hong Kong issuers with additional requirements on chapter on Climate Change
	Canadian Securities Administrators (CSA) publishes guidance to assist companies in identifying and improving their disclosure of material risks posed by climate change
	IMF Global Financial Stability Report states policymakers have a role to play in promoting integration of climate change considerations into investments and business decisions
	RBA in Financial Stability Review states: "Climate change will have a broad-based impact on Australian financial institutions and therefore clearly poses risks that are systemic in nature."
	The Governor of the Bank of England warns private sector has two years to establish credible rules for reporting climate risks before global regulators devise their own and make them compulsory
	IMF concludes the longer we wait to address climate change, the greater the loss of life and damage to the world economy. Will undertake country and sector level analysis of climate-risks
	Hong Kong Monetary Authority unveils three sets of measures to support and promote Hong Kong's green finance development
	Japanese government forms the TCFD Consortium to support and stimulate industry and investor reporting efforts and hosts the first TCFD Summit in Tokyo
	Bank of Japan announces it will evaluate climate-related risks for Japan's financial stability
	New Zealand's Aotearoa Circle's Sustainable Finance Forum publishes legal opinion to clarify the legal obligations of directors and fund managers are required to take account of climate change in their decision making

Source: Investor Group on Climate Change

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