

# Investor expectation on company climate change risk disclosure

Investors expect three key aspects of a company's climate change risk approach to be disclosed. They expect a clear articulation of the nature of material climate change risks and the impact on both short and long term strategy and competitiveness. Secondly, they expect a quantification of the risk and level of uncertainty that surrounds any risk assessment. Finally, investors expect a description of the risk management, mitigation and adaptation actions identified and the level of any residual/acceptable risk. Investors recognise the area of climate change risk is a rapidly evolving one; one that continues to demand a greater level of sophistication in disclosing those risks to investments.

## CLIMATE CHANGE: A SYSTEMIC, LONG TERM RISK FOR INVESTORS

Understanding and managing an effective response to climate change is one of the greatest challenges facing modern economies. The scale of the structural changes within and between economies as a result of the drive to significantly decrease greenhouse gas (GHG) emissions and adapt to new climatic conditions will leave almost no sector in the economy untouched. Some will be impacted by government policy or regulation to reduce emissions, such as emissions trading schemes; others will be affected by the increase in climate variability, while others will be affected by long term climate changes. Some sectors will be affected by all three.

As with other risks facing companies, investors need to understand the nature of climate change risk as well as how companies, on behalf of their shareholders, are managing this risk.

Although institutional investors, such as pension and superannuation funds, invest in all sectors of the domestic and international economy and across all assets classes, the systemic nature of the climate change risk can neither be diversified away, nor managed effectively, through active investment management. Being so limited, investors are reliant on individual companies to manage the collective risk climate change represents to investors.

The importance of this risk to institutional investors is reinforced by its long term nature and how this matches potential long term liabilities or responsibilities to provide superannuation returns.

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## INVESTORS RESPONSE TO THE CLIMATE CHANGE RISK

Recognising the importance of climate change risk, investors have set up a number of collective investor initiatives, such as:

- ▶ Investor Group on Climate Change
- ▶ Institutional Investor group on Climate Change
- ▶ Investor Network on Climate Risk
- ▶ UNEP FI Climate Risk working group.

These groups work to develop a better understanding of climate change risk as it applies to investors, contribute to the public policy response and encourage the timely and appropriate disclosure of climate change risk by companies.

Increasingly, sell-side analysts are researching the potential impact of climate change on company value and individual investors are assessing exposure of portfolios to climate change risk, eg VicSuper in Australia and Henderson Investors in the UK. (A sell-side analyst works for a brokerage firm and evaluates companies for future earnings growth and other investment criteria.)

## DISCLOSURE NEEDS OF INVESTORS

The investor need to make informed investment decisions and manage investment risk drives the demand on a company to disclose how it is managing its climate change risk.

The disclosure expectations of investors are different from other stakeholders in both their scope and detail. This has meant that emissions disclosure and associated discussion through company sustainability reports is often insufficient for investors. There are a number of reasons why this should be so:

- ▶ The disclosure of emissions from managed operations is not aligned to the exposure of investors, who are exposed to the emissions based on their equity interest in operations.
- ▶ The greatest exposure to investors may be through suppliers or customers and the management of the value chain.

Physical climate risks, such as floods, forest fires and rising seas will all have profound effects on companies in the decades ahead.

- ▶ The mechanism for managing the risk, through financial risk products may be inappropriate for the normal audience of a sustainability report.
- ▶ Financial risk to investors may be, in the short term, limited to emissions covered by an emissions trading scheme, which may not cover all company emissions.

## INVESTOR EXPECTATIONS

There are a number of frameworks developed by investors to facilitate the appropriate level of disclosure on climate change risk by companies. These include the Carbon Disclosure Project and the Global Framework for Climate Risk Disclosure. All frameworks focus on three key areas of disclosure:

- ▶ Clear articulation of the nature of material climate change risk or opportunity facing the company and, in particular, the impact on both short and long term strategy and competitiveness
- ▶ The quantification of the risk and the level of uncertainty that surrounds any assessment of the risk
- ▶ The description of the risk management, mitigation and adaptation actions identified to address the risks and the level of any residual/acceptable risk.

This framework will be familiar to many companies as it mirrors the structure of risk disclosure required by investors of other company risks.

### Clear articulation of material climate change risk

The key issue for investors is material climate change risk and this is the starting point for any disclosure by companies. To demonstrate to investors that a systematic approach to climate change risk has been undertaken, companies should disclose which risks they have considered and why they believe a particular climate change risk is not material, noting that current uncertainty in either understanding of climate change impacts or regulation are not reasons *per se* for discounting the risks.

Similarly, companies may often see opportunities that might arise as a result of climate change. As noted, the three likely areas of risks faced by a company are:

- ▶ Regulatory risk
- ▶ Physical risk
- ▶ Value chain risk.

Investors recognise that each risk tends to be multidimensional and look for companies to demonstrate a clear and systematic analysis of all dimensions of the risk both as they may exist at present and in the future. Regulatory risks may be as a result of the new performance standards, eg for energy efficiency standards for properties, appliances or vehicles, or result in a cost on emissions or other input costs, eg through an emissions trading scheme or carbon tax. In some cases, climate change may increase an existing regulatory risk, eg planning approval for an energy intensive or greenhouse intensive operation, such as a coal mine.

Physical risk may be as a result of direct weather related impacts of extreme weather events and an increase in climate variability. It may also be indirect, such as effects on water supplies or human health, eg heat related illness or an increase in pests and diseases.



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Value chain risks are probably the least well understood or assessed by companies. Investors are looking for an assessment of both the supply and customer side of the value chain, considering both physical and regulatory risks and the impact of potential climate change adaptation or risk management options that the value chain players may adopt.

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In disclosing the analysis of the risks, investors are looking for an analysis of the strategic and competitive implications of a particular risk and how this may affect the growth or risk profile of the company.

Many companies, particularly service sector companies, focus on the risks associated with their own direct or indirect greenhouse gas (GHG) emissions. While this may be the most recognisable, quantifiable and perhaps most easily managed risk, the emissions are not the principal climate change risk facing the company.

VISIT: [WWW.CLIMATEACTIONPROGRAMME.ORG](http://WWW.CLIMATEACTIONPROGRAMME.ORG)

Investors recognise that addressing climate change may be part of a broader strategic positioning for a company, eg brand enhancement or employee values alignment. If this is so, then this should be articulated. The danger for companies is that focusing on potentially less important climate change risks, without putting them within a strategic/competitive advantage context may mean that more significant risks are not addressed or actions are ineffective.

### Quantification of climate change risk

The challenge for companies is to demonstrate to investors that they have adequately quantified the climate change risk. Investors recognise this is an evolving area as a result of uncertainty in regulation and uncertainty in the physical impacts of climate change. However, companies need to demonstrate that they understand the risks, notwithstanding these uncertainties.

Clear disclosure of assumptions used in scenarios, eg price of carbon, time for introduction of a trading scheme or increased frequency/intensity of weather extremes or interruptions, is necessary to enable investors to assess the veracity of the scenarios.

For those companies significantly, directly, or indirectly impacted by a price on carbon, the most important disclosure is the emissions profile. Investors are looking for disclosure on an equity basis:

- ▶ Total actual historic direct and indirect absolute emissions by GHG
- ▶ Total current direct and indirect emissions by GHG
- ▶ Expected changes in emission profile in future years
- ▶ Direct and indirect GHG emissions by division for diversified or vertically integrated companies
- ▶ Direct and indirect GHG emissions covered by emissions trading scheme or other carbon price
- ▶ The basis for and level of accuracy of reported emissions
- ▶ Operations or gases not covered by data
- ▶ Current and future permits/credits given through any emissions trading allocation process or through CDM/ Joint Implementation projects.

Investors are looking for companies to use the most widely agreed upon international accounting standards. This is the Corporate Accounting and Reporting (revised edition) of the Greenhouse Gas Protocol, developed by the World Business Council of Sustainable Development and World Resources Institute.

A key step is quantifying the consequence on the growth and risk profile of the company and the company's assessment of the likelihood and timeframe of the particular climate change risk scenario. The basis for the company's assessment of the materiality or significance of the risk of the scenario should also be disclosed.

### Risk management, mitigation and adaptation

There are three additional aspects that companies should disclose to investors:

- ▶ The relationship of climate change risk with other risk management processes within the company, in particular responsibility and reporting
- ▶ The specific current and future risk mitigation and adaptation actions or options

- ▶ The potential residual climate change risk, including the potential for stranded assets.

In discussing risk mitigation and adaptation actions, investors are interested in both the strategic risk mitigation and adaptation actions with respect to new investments and existing operations.

## CONCLUSION

The systemic nature of climate change risk to investors and, in particular, long term institutional investors means usual diversification or active investment tools are inadequate for these investors to manage their climate change risk. As a result, these investors rely heavily on the climate change risk management of their investments to manage the risk.

This reliance leads to increased investor expectations on the level and detail of climate change risk disclosure by companies. Investors have worked together to outline their expectations through initiatives such as the Carbon Disclosure Project and the development of the Global Framework for Climate Change Risk Disclosure. Investors expect three key aspects of a company's climate change risk approach to be disclosed as already discussed.

The area of climate change risk is a rapidly evolving area as a result of international and national regulatory changes, societal expectations and increased confidence in the accuracy of predicted physical impacts of climate change. As a result, investors will continue to expect a greater level of sophistication in the disclosure of the climate change risks of their investments.

### Author

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### Organisation

AMP Capital Investors is an Australian based specialist investment manager with over \$111 billion (AUD) in funds under management. AMP Capital Investors is the investment arm of AMP Ltd, a leading Australian based wealth management company.

The Investor Group on Climate Change (IGCC) is a collaboration of Australian and New Zealand investors focussing on the impact that climate change has on the financial value of investments. The IGCC aims to ensure that the risks and opportunities associated with climate change are incorporated into investment decisions for the ultimate benefit of individual investors.

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