GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

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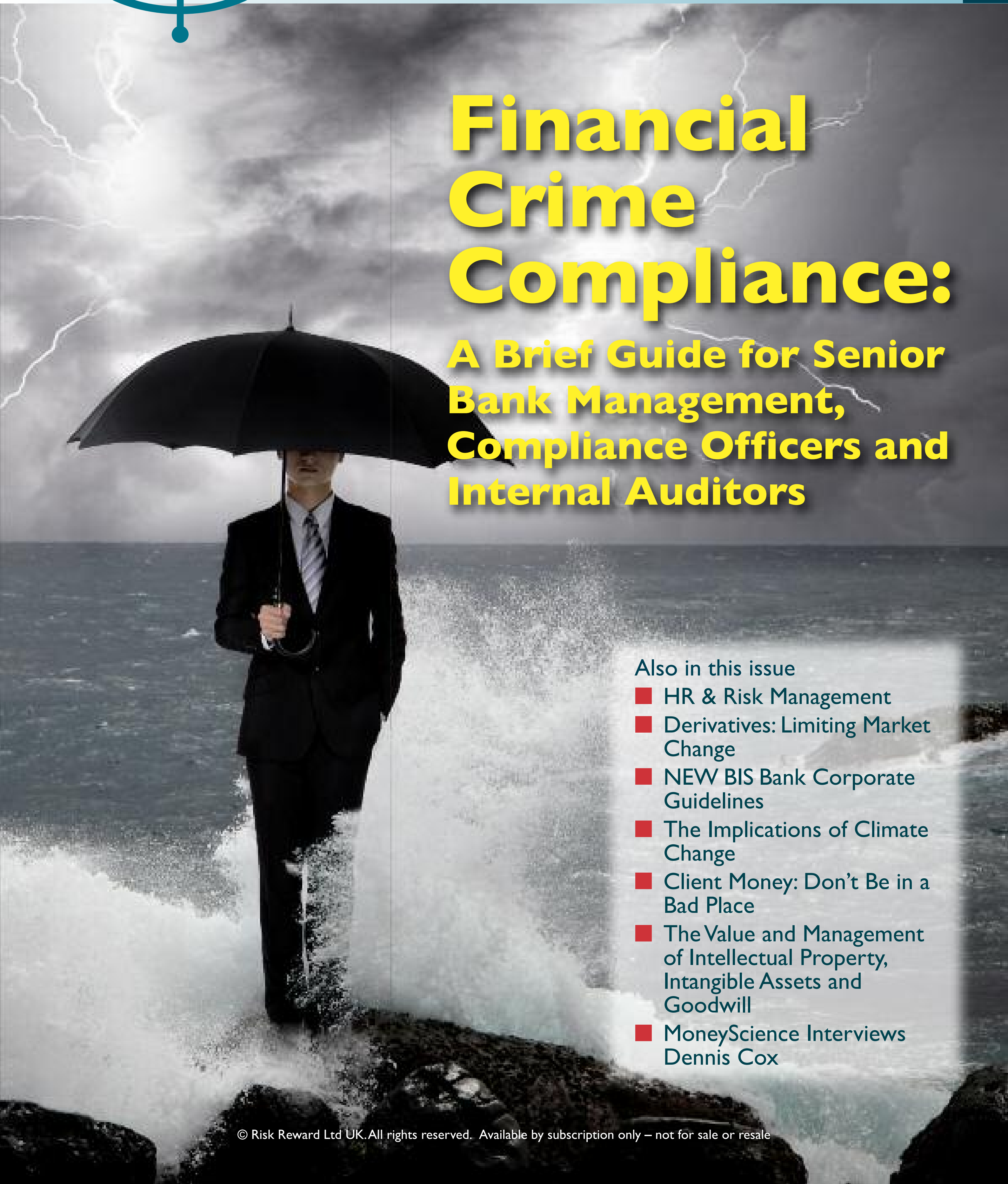

Financial Crime Compliance:

A Brief Guide for Senior Bank Management, Compliance Officers and Internal Auditors

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The Implications of Climate Change Risk

David A. Thompson, FCA is a chartered accountant and turnaround business leader based in the UK for more than 30 years. As part of a fund raising unit for technology firms seeking to exploit innovations in the global environment and energy sectors he sees climate change risk impacts firms and their funders alike. In this article he explores how an awareness of the existence of Climate Change Risk in all its guises is essential for all financial institutions investing in or to lending to businesses wherever located but particularly those businesses operating in parts of the world that are subject to greater climate change regulation and/or frequent extreme weather events.

Whatever your views on Climate Change – natural or man-made or a bit of both - it is clear that no business (or government) can ignore recent extreme weather events and the momentum that is starting to build amongst world governments towards more action and regulation aimed at reducing carbon and other greenhouse gas (GHG) emissions which are thought to contribute to climate change. Whilst much of the impact of additional regulation is likely to fall on the major emitters in the energy and power generation sector, there is no doubt that climate change in all its aspects will become of greater import to the wider global business community.

Although great efforts are being made on the global stage through organisations like the United Nations on the need to combat climate change by reducing the Greenhouse Gases (GHGs) emissions, the lack of global action is the wrench in the wheel slowing this battle against climate change. On September 23rd 2014 more than 120 Heads of State attended the United Nations Climate Change Summit in New York under the mantra of catalysing action for the run up to the 21st Conference of Parties (COP) in Paris 2015 and post 2020 commitments. Although this summit generated mass media coverage of the awareness that further action must be taken to combat climate change, it yielded little in the way of new commitments which only increases the uncertainty in the international regulatory environment. Furthermore, key political leaders in China, India, Russia, Germany and Australia emissions failed to attend this summit in New York which sends a signal of a lack of global consensus leading to further uncertainty at the global level.

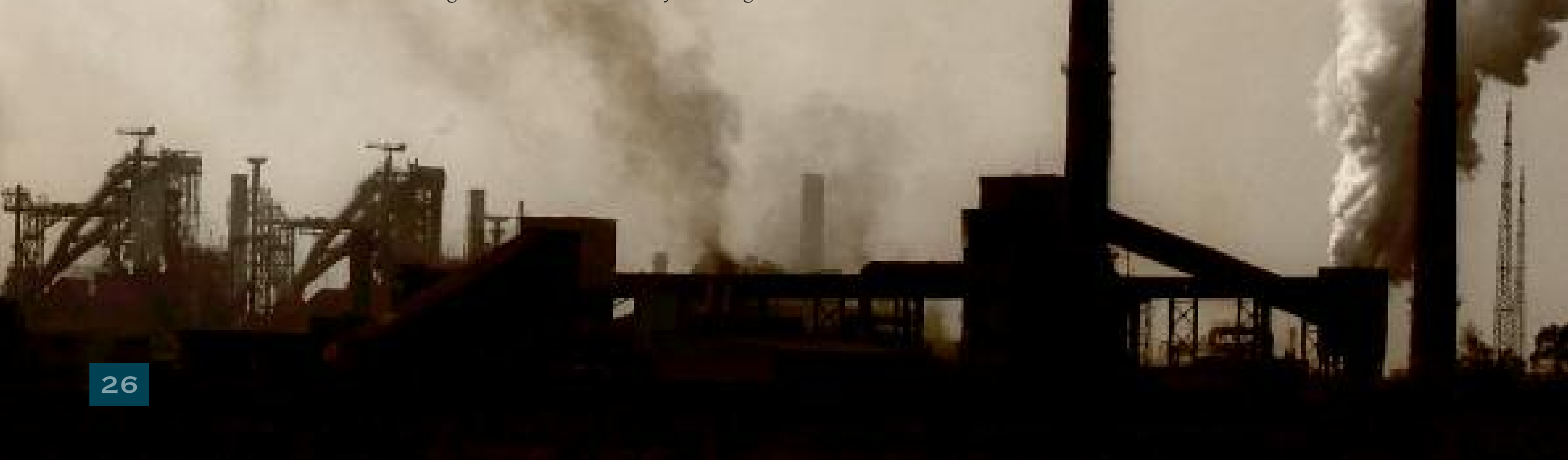
It is clear that 'something' must be done to reduce GHG emissions however, the what and the how is still a topic open to wider debate and varying opinions which have lead to divergences in the response of countries to climate change. These divergences have led to risks facing businesses due to climate change varying from country to country.

In this article we consider the various aspects of climate change risk facing UK businesses – all 4.9 million of them – trading domestically and internationally.

In general, for each aspect of Climate Change Risk all organisations will have to consider:

a) The potential impact
b) Timeframe involved
c) Whether or not the Risk is Direct or indirect
d) The likelihood of occurrence and
e) Magnitude of the impact

For the purposes of this discussion Climate Change Risk can be categorised into 2 main areas which we will examine in turn: the impact of regulation and the impact of extreme weather events.



I The Impact of Regulation

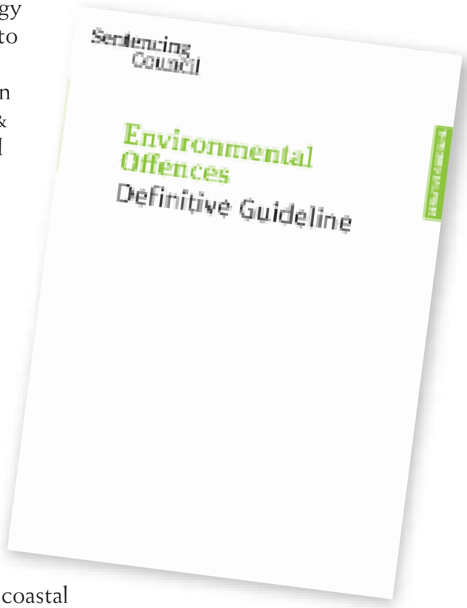
The UK is one of the 28 member countries part of European Union Emission Trading Scheme (EU ETS) which means that the UK businesses with installations that meet European Commission (EC) criteria[1] are subject to the rules and regulations dictated by the EC. These regulations relate to issues surrounding the Cap-and-Trade system for example the cap of the installation, the monitoring, reporting and verification (MRV) process, the allocation of allowances which all fall under the National Allocation Plan (NAP). In addition to this the UK has its own country specific regulations on climate change stemming from the Climate Change Act 2008 which set a legally binding target to reduce UK's GHG emissions by at least 80% by 2050.

With regard to UK businesses one of the most pressing regulations is the recent introduction of mandatory carbon reporting for companies listed on the London Stock Exchange (LSE) to publish full details of their GHG emissions[2]. The idea is that creating more transparency through the financial statements, will allow public perception to shape the decisions of investors and consumers by employing the forces of public pressure. The perceived risks to business is linked to reputational risk where companies with activities that damage the environment and inadequate steps are being taken to mitigate this, these companies will suffer from a loss of business as investors and consumers choose other cleaner companies. At the times of this article mandatory carbon reporting only applies to companies listed on the London Stock Exchange however there are talks of extending this beyond listed companies.

In July 2014 the new Sentencing Council Guidelines came into effect where a tariff-based approach to the sentencing of environmental offences was introduced where criminal courts will be required to take account of the guideline when sentencing wrongdoers. Also the size of the penalties for environmental offences[3] has increased[4] for example for large organisations where turnover is greater than £50 million can face fines up to £3 million. Furthermore, fines in the hundreds of thousands will become more the standard rather than the exception. Therefore the risks of non-compliance to business are the loss of revenue and the potential of reputational damage following the sentencing.

There are a number of issues that businesses need to be aware of to avoid the implications of climate change risk but also benefit from the changes in regulations;

a) Changes being needed in product ranges and associated production technology and facilities due to changes in demand for certain items (low carbon v high carbon – e.g. the motor vehicle industry),
b) Product specifications needing to be reviewed to comply with new regulation,
c) Increase in the cost of R&D into low carbon products
d) Changes to the skill sets required by employees
e) Changes in local government planning requirements resulting in higher standards being set for building projects leading to development projects being delayed or shelved.
f) Increased capital expenditure costs to meet new standards,
g) A move towards greener energy solutions (which are generally more expensive),
h) Reduction in government subsidies for Green energy further increasing the cost to business
i) The introduction of carbon pricing schemes (e.g. Cap & Trade as in the EU Emissions Trading scheme, the Auctioning of Carbon Allowances or Taxation), leading to additional administrative burdens and costs,
j) More regulation giving rise to increased monitoring by the authorities and stricter enforcement and higher penalties for failure to comply fully with regulations.
k) Reduced public expenditure on waterways, coastal management and other projects intended to mitigate the effect of Climate Change resulting in weaker flood defences leading to increased risk to businesses and communities located in coastal, low lying and other vulnerable areas.



The risks and opportunities stemming from climate change policy are increasingly becoming more perception based, therefore companies which invest in greener technologies and have more environmentally friendly activities can benefit from a boost in its corporate social responsibility image which improves the brand status.

However, before taking any action, businesses should seek to quantify:

- The potential financial implications of the risk
- The methods proposed to manage the risk
- The costs associated with such proposed methods

This process is critical to mapping the extent to which embedding a green culture within a company can benefit or

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[1] These include power stations, oil refineries, offshore platforms and industries that produce iron and steel, cement and lime, paper, glass, ceramics and chemicals. Also depending on the level of combustion, universities and hospitals may be included. Lastly, aviation operators flying into or from a European airport are also covered by the EU ETS.

[2] Starting in October 2013

[3] The unlawful deposit of waste and the discharge of polluting matter into the air, freshwater or groundwater

[4] Subject to the nature of the offence i.e. no culpability, negligent, reckless or deliberate

cost the company which will ultimately determine the pace at which the 'green' pivot will happen for the UK businesses.

II Risk driven by changes to the weather or climate

There have always been extreme weather events however it does seem that these have been occurring with greater frequency. No business, wherever located, can afford to discount the possibility and ignore the consequences of an extreme weather event. The challenges that UK businesses face stem largely from flooding and coastal erosion, increased competition for water, energy and materials; and the disruption of transport networks and communication link.

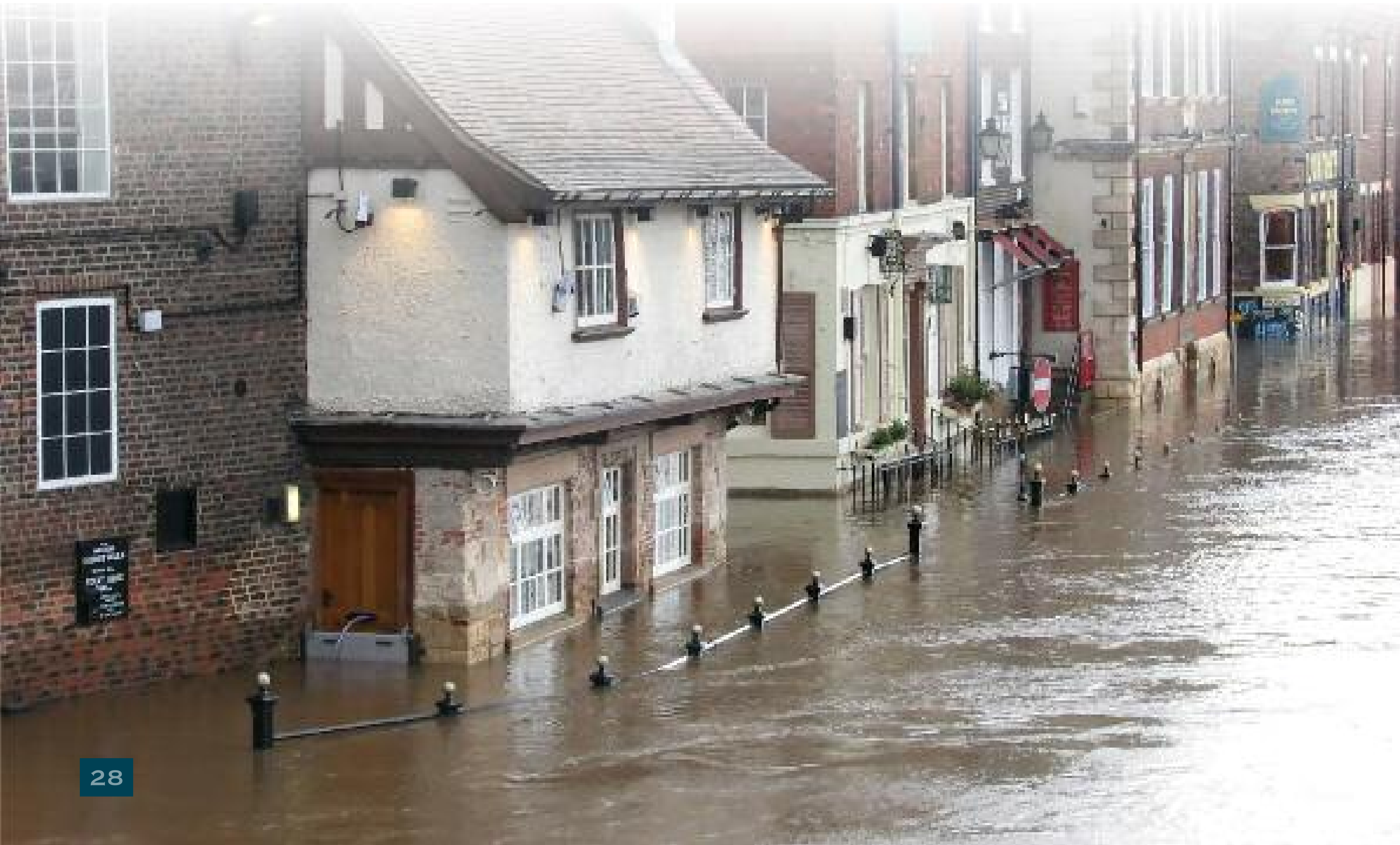
In recent years we have seen searing heat waves over the summer months with falling levels of rainfall to some of the coldest, fiercest winters in decades and the worst flooding in a century. Changes in the frequency and intensity of rainfall and with trends indicating increasing the flooding frequency, businesses previously used to operating in relatively benign climatic conditions, particularly those located in near river systems or in low-lying and/or coastal areas, should consider how to mitigate the risk of damage to infrastructure and disruption to the business operations.

Businesses that rely largely on fixed assets especially near main rivers or the coast, or have complex supply chains or rely substantially on natural assets have a particular acute risk to changes in the climate dynamic. Although, it is likely that the risk of operating in such extreme conditions has been a major part of operating considerations for many years but with climate change the frequency, duration and magnitude of weather events have changed and businesses must have the ability to accurately risk assess these changes to weather.

For UK business the main risks factors[5] are:

- Possible decrease in output for UK businesses due to an increase in supply chain disruption as a result of extreme events.
- Risk of increase in monetary losses as a result of interruption to business from flooding.
- Greater variability in the availability of water.
- Potential loss of staff hours due to high internal building temperatures (assessed as being of particular relevance to health, education and retail sectors, which have large workforces).

Businesses that are not directly subject to the main risk factors should be aware of the interconnectivity of the domestic to the international economy. For example disruptions to the transport links can have a knock on effects that ripple through the economy or businesses with international supply chains have to be ever vigilant of how climate change is affecting other parts of the world.



The Implications of Climate Change Risk

In planning for such extreme weather events, businesses should consider:

a) The Impact on operating costs
b) The Impact on Capital expenditure on defensive/protective measures
c) Loss of productive capacity
d) Employee welfare and safety
e) The possibility of damage caused by an extreme weather event to business infrastructure resulting in environmental damage/pollution due to key systems failures, the direct cost of rectification, compensation to local population and loss of reputation.

In the face of all these risks due to weather changes there are also some opportunities which businesses can be leveraged for example warmer summers in the UK can provide market opportunities to especially the tourism and leisure industry.

Investors and Lenders

Awareness of the existence of Climate Change Risk in all its guises is essential for all financial institutions investing in or to lending to business wherever located but particularly those businesses operating in parts of the world that are subject to greater climate change regulation and/or frequent extreme weather events.

An examination of Climate Change Risk and the impact of an extreme weather event on a business, its profitability, cash flow and its ability to recover operations following such an event i.e. the insurance policies surrounding weather damage should be included in Due Diligence process alongside the more usual risk considerations. In high risk businesses it is likely that Investors already plan for these eventualities in their risk assessment. In addition to this investors also need to be aware of the inter-connections between businesses and understand how sectoral responses to climate change may lead to changes in the risks that they have to manage[6] when considering where to invest their money.

Corporate Governance

With the onset of mandatory carbon reporting for UK businesses listed on the LSE businesses will be required to include carbon information within their director's report which one or more committees will need to sign off internally. The predicted effect of this is that mandatory carbon reporting should raise the profile and importance of climate change to senior level executive.

In addition mandatory carbon reporting will ensure that the work that environmental managers do to measure, collect and report on sustainability data will gain greater recognition from a variety of departments. This will largely be due to the requirement to publish this data within annual reports, rather than only within standalone sustainability reports[7].

Mandatory carbon reporting will improve the status and importance of Climate Change Risk and the management of GHG emissions as a routine item on the agenda of Board level and Senior Management meetings. However, the question is whether mandatory carbon reporting alone will be enough to change the climate change culture of a company which is of course dependant on how climate change risk can be embedded into the corporate governance structure.

What is sure though is that businesses seeking to expand into new geographical areas along with their funders will have to give major consideration to the possible impact of Climate Change Risk.

Conclusion

Climate change is upon us - whatever the cause - and the impact is being felt now. Without action it may only worsen for future generations for many years to come. In the meantime, all businesses and lenders must ask if their organisation has considered the impact of Climate Change and the current and future Climate Change Risks that may result in major changes to compliance, operations and profitability.

The author invites feedback via email at DAT@riskrewardlimited.com

[5] *HM Government UK Climate Change Risk Assessment: Government Report (January 2012)*
[6] *Ibid*
[7] *Source: Laura Paddison - Mandatory carbon reporting: can it address climate change? (July 2013)*

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