Finanstilsynet
governance@ftnet.dk

Klosterport 4 E, 1.sal
DK - 8000 Aarhus C
Tel: +45 86 76 04 44
www.ve.dk
www.ansvarligfremtid.dk
D 3. juli 2017
R Lars Jensen
E lje@ve.dk

Fit & Proper-reglerne og klimarelaterede finansielle risici

Høringssvar til Finanstilsynets diskussionspapir af 22.maj 2017

Vi vil gerne takke for muligheden for at komme med synspunkter i forhold til Finanstilsynets diskussionspapir omkring Fit & Proper-reglerne. Det er positivt at der åbnes bredt op for synspunkter i forhold til en videreudvikling af det relevante tilsyn. Vores hovedsynspunkt er uændret i forhold til vort brev til Erhvervsministeren af 4. januar 2017, at lovgivning om klimarelaterede risici bør implementeres med tilstrækkeligt tilsyn i Danmark.

Generel baggrund

Baggrunden for vore synspunkter er vores erfaringer fra de seneste fire års arbejde med at rejse pensionsopspareres bekymring for, at pensionskasser og -selskaber ikke tilstrækkeligt tog hensyn til klimarelaterede risici i forvaltningen af deres pensionsopsparing.

Da Finanstilsynets diskussionspapir flere steder refererer til britisk regulering har vi spurgt advokater hos ClientEarth's Londonkontor om baggrundsinformation. ClientEarth har en generel juridisk interesse i klimaregulering herunder hvordan dette adresseres i finansiel regulering. Information fra et internt arbejdsdokument fra ClientEarth har informeret nogle af synspunkterne udtrykt i dette høringssvar. ClientEarth har en interesse i udviklingen på dette område i Europa, som relevante anledninger viser sig.

Vi har desuden forespurgt hos Sarah Barker fra det australske advokatfirma MinterEllison, da hun er kendt som en global juridisk kapacitet i forhold til juridisk ansvar i forbindelse med klimarelaterede finansielle risici. Vi vedlægger en række juridiske notater, som MinterEllison har offentliggjort i denne forbindelse.

Globalt kan meget af det nuværende arbejde med klimarelaterede finansielle risici føres tilbage til en rapport, der blev udgivet i 2011 af aktører i Londons finansmiljø. I rapporten sammenlignes klimarelaterede finansielle risici (dengang kaldet "kulstofboblen") med dot.com-boblen omkring 2000 og kreditboblen omkring 2008:
"In the past decade investors have suffered considerable value destruction following the mispricing exhibited in the dot.com boom and the more recent credit crunch. The carbon bubble could be equally serious for institutional investors – including pension beneficiaries - and the value lost would be permanent."[1]

Denne rapport fra 2011 har givet anledning til meget forskelligartet aktivitet siden fra kreativt kunsteriske divestmentkampagner, der refererer til rapportens data, men ikke dens anbefalinger til tilsynsmyndigheder, til højtkvalificeret finansielt analysearbejde som de

---

[1] Leaton, James: *Unburnable Carbon – Are the world's financial markets carrying a carbon bubble?* Rapport CarbonTracker Initiative 2011. http://www.carbontracker.org/wp-content/uploads/2014/09/Unburnable-Carbon-Full-rev2-1.pdf tilgået. 30.6.17

netop offentliggjorde TFCD anbefalinger[2]. Det har dog endnu ikke givet anledning til internationalt orienteret videnskabelig forskning inden for det erhvervsøkonomiske felt finansiering.[3] Dette er så påfaldende, at tidsskriftet Climatic Change, hvis redaktør prof. Michael Oppenheimer også var en koordinerende lead author for den nyeste statusrapport fra FNs klimapanel, for nyligt har publiceret forskning herom[4].

1. Overordnede synspunkter

1. Virksomhedens ansvar ift. klimarelaterede finansielle risici bør placeres eksplicit.
Det er vort klare synspunkt, at ansvaret for klimarelaterede finansielle risici bør fremgå udtrykkeligt og eksplicit af en opdateret dansk fit&proper-regelsæt, for alle typer af finansielle virksomheder. Vi ser dette som en naturlig erhvervsmæssig implementering af Regeringens politik om, at Danmark nationalt skal bidrage til indfrielse af den ambitiøse målsætning i Klimaaftalen fra Paris.

2. Scenarieanalyse kan benyttes i forbindelse med klimarelaterede finansielle risici.
Uagtet hvilken politisk holdning man måtte have til klimavidenskaben, divestmentkampagner eller brændselsfrie energiteknologiers evne til kommercielt at udkonkurrere brændselsbaserede, så kan klimarelaterede finansielle risici fagligt benyttes som et muligt scenarium i evaluering af eksisterende og evt. reviderede fit&proper-regler. Et sådant scenarie kunne fx være at der 2022 sker en væsentlig realisering af klimarelaterede finansielle risici i den globale finansielle sektor.[5]

Rimeligvis må det være et kriterie for velfungerende fit&proper-regler, at de forebygger, at et sådant scenarie påvirker danskerne og det danske finansielle system negativt. Dette kan evt. også betyde – hvis man mener, at det at have et ansvar indebærer, at et ansvar skal kunne gøres gældende – at det skal sikres at et ansvar skal kunne placeres, hvis der alligevel indtræder negativ påvirkning af danskerne og det danske finansielle system, som følge af, at ansvaret ift. klimarelaterede finansielle risici ikke er blevet løftet.

2. Synspunkter om klimarelaterede finansielle risici i forhold til enkeltafsnit i diskussionpapiret

2.2 Detaljeret kortlægning af kompetencer og ansvar ift. klimarelaterede finansielle risici

(jf. diskussionspapirets afsnit 2.2). Tommelfingerreglen: "Det der bliver målt bliver gjort" må formodes at gælde her som i så mange andre sammenhænge. At få kortlagt hvilke ansvarsområder, der findes i forhold til forskellige risici herunder navnlig klimarelaterede finansielle risici må formodes at styrke fokus på at disse bliver håndteret.
Hvor ansvaret for klimarelaterede finansielle risici bør beskrives udtrykkeligt i en kortlægning af ansvaret og det bør sikres at den, der har dette ansvar, har relevante kvalifikationer til behandle klimarelaterede finansielle risici inden for sin risikohåndteringsfaglighed. Det kan her bemærkes at for fx forsikringsselskaber påvirker

---

[2] https://www.fsb-tcfd.org/publications/final-recommendations-report/ tilgået 30.6.17
[3] I den danske litteratur findes denne artikel: Jensen, Lars N. (2015): "Bør der regnes på strandede aktiver? Betydningen af et begrænset carbonbudget for værdien af kul-, olie- og gasselskaber", *Finans/Invest* (5)2015 p. 30-37
[4] Diaz-Rainey, I., Robertson, B. & Wilson, C.: "Stranded research? Leading finance journals are silent on climate change" *Climatic Change* (2017) 143: 243. doi:10.1007/s10584-017-1985-1
[5] Den tekniske supplementsrapport fra TCFD konkretiserer brugen af scenarier yderligere. https://www.fsb-tcfd.org/publications/final-technical-supplement/ tilgået 30.6.17

klimarelaterede finansielle risici påvirker både aktiv- og passivside. Der bør være et samlet ansvar for behandlingen af klimarelaterede risici på både aktiv- og passivside. Såfremt der benyttes forskellige antagelser på aktiv og passivside må kortlægningen vise, hvem der har ansvar for at der benyttes et forsigtighedsprincip i disse antagelser.
Det kan evt. overvejes om kompetencegivende efteruddannelsesforløb kan være relevante i denne sammenhæng, hvor også kursusbeskrivelser kan hjælpe med at definere hvilket kompetenceniveau der forventes for at varetage ansvaret med klimarelaterede finansielle risici.

(jf. diskussionspapirets afsnit 2.3) Ud fra de britiske erfaringer kan det synes relevant allerede på interviewstadiet at forholde sig til opmærksomheden på klimarelaterede finansielle risici.

(jf. diskussionspapirets afsnit 2.5) Det kan endvidende synes relevant at føre løbende tilsyn med at tidligere godkendte personer fastholder deres fit&proper-niveau i forhold til klimarelaterede finansielle risici, som det kendes fra andre ansvarsfyldte erhverv som fx piloter.

2.7 Ansvar i forbindelse med klimarelaterede finansielle risici

(jf. diskussionspapirets afsnit 2.7)
I den globale juridiske debat om klimarelaterede finansielle risici citeres Graeme Samuel den tidligere leder af the Australian Competition and Consumer Commission af og til for at skulle have sagt: 'Nothing focuses the mind like the spectre of personal liability'

Nogle vil muligvis mene, at diskussionspapiret rummer en selvmodsigelse, når der skrives at risikoen for strafansvar vil gøre det vanskeligt at tiltrække kvalificerede ledelsesmedlemmer, i hvert fald hvis der med kvalificeret menes en person som samvittighedsfuldt og kompetent sikrer at virksomheden håndterer sine klimarelaterede finansielle risici. Hvis personer, der ikke har til hensigt at samvittighedsfuldt og kompetent at håndtere sådanne risici måtte vælge at søge til mindre regulerede brancher, hvor der er mindre mulighed for at påføre skade på danskernes penge og det danske finansielle system, så må dette vel anses for ønskværdigt ud fra et samfundsmæssigt perspektiv.

Hvis man som et fiktivt eksempel forestillede sig, at en bestyrelsesformand på en general-forsamling i sin beretning udtrykkeligt sagde: "Loven kræver, at vi som bestyrelse har pligt til at passe på jeres penge. Vi traf dog på det første bestyrelsesmøde efter vi blev valgt en beslutning om at ignorere den lovgivning. Som konsekvens af den beslutning er jeres penge nu væk." I dette tilfælde vil en almindelig retsintuition sige, at det bør være muligt at gøre et ansvar gældende.

Retspraksis synes dog at indikere, at domstolene inden for den gældende regulering har ganske svært ved at skelne mellem et uheldigt udfald inden for en almindeligt fornuftigt udfaldsrum (som næppe bør føre til sanktion) og beslutninger, der indebærer udfaldsrum der rummer uansvarligt negative udfald (som måske nærmere bør føre til sanktion). Det kan derfor synes relevant at arbejde videre i retning af objektive kvantitative kriterier, der kan hjælpe domstolene med at identificere de sidstnævnte typer tilfælde. Måske kunne det indebære at reguleringen skulle angive at et signifikansniveau i en identificeret relevant statistisk test på virksomheden data skal tolkes som et bevis ud over enhver rimelig tvivl. En sådan regulering kunne evt. kalibreres på sager fra dotcomboblen og kreditboblen, og fremadrettet indikere den acceptable risiko i forhold til klimarelaterede finansielle risici. Politisk bør en sådan kalibrering reflektere Regeringens politik om, at Danmark nationalt skal bidrage til indfrielse af den ambitiøse målsætning i Klimaaftalen fra Paris.

2.1 Medlemsindflydelse og kompetencer i ledelsen

(jf. diskussionspapirets afsnit 2.1) "Bør medlemmernes indflydelse udøves gennem et repræsentantskab?" er et spørgsmål tilsynet stiller. Hvis alternativet er direkte medlems-indflydelse på en generalforsamling er svaret nej.

Generelt er det et stort problem, at danskerne ikke interesserer sig nok for deres pension. Hvis den begrænsede interesse der er derefter skal via et repræsentantskab vil det gøre signalerne til ledelserne fra medlemmerne endnu svagere. Hvis en direkte dialog med medlemmerne opleves som ubehagelig af ledelsen kan det jo netop være udtryk for at den har haft elementer af det group think, som tilsynet ellers (jf. diskussionspapirets afsnit 2.5) foreslår at løse med antropologer, adfærdspsykologer eller lignende. Disse udmærkede fagligheder har imidlertid ikke hånden på kogepladen som medlemmerne har. Der findes eksempler på medlemsejede både forsynings- og forsikringsselskaber, hvor medlemsind-flydelsen og -kontrollen via repræsentantskaber er blevet så svag, at betegnelsen "herre-løse penge" er passende, og hvor der som følge heraf synes at have fundet værdidestruk-tion sted.

Det kan ikke udelukkende at en ufokuseret værdidestruerende ledelse, hvis en sådan måtte findes, vil have lettere ved at sove i fred, hvis den på en retorik om kompetence via et repræsentantskab undgår kritiske spørgsmål fra medlemmerne. At der kan være behov for at styrke myndighedernes tilsyn bør ikke være et argument for at svække medlemmernes tilsyn, tværtimod.

Det er vigtigt at udtrykkeligt sikre kompetencer i forhold til klimarelaterede finansielle risici som en nødvendig faglig kompetence blandt de økonomisk faglige bestyrelsesmedelmmer. Medlemsvalgte bestyrelsesmedlemmer kan supplere økonomisk faglige bestyrelses-medlemmer i forhold moral, sund fornuft, ejerforankring og bredere samfundsinteresser.

2.8 Corporate governance generelt

(jf. diskussionspapirets afsnit 2.8) For at undgå misforståelser er det væsentligt at påpege at klimarelaterede finansielle risici hører hjemme inden for betragtninger om det risikojuste-rede afkast. Det er således separat fra de ESG-spørgsmål som blandt andet reguleres af UN Guilding Principles on Business and Human Rights, Direktivet om ikke-finansiel rapporte-ring, ÅRL §99a mv. De klimarelaterede finansielle risici kan dog mindskes ved at sikre at ejede selskaber ikke benytter kontanter til at bygge ny infrastruktur til udvinding og transport af fossile brændsler. Nogle har det synspunkt at aktivt ejerskab kan stoppe en sådan brug af ejernes kontanter.

Jf. afsnittet ovenfor om medlemsindflydelse gør et stærkt medlems-/ejerdemokrati med direkte medlemsindflydende på en generalforsamling (dvs. ikke via et repræsentantskab) et andet tiltag til at styrke virksomhedens governance end et regulatorisk tiltag. Det har vist sig også at kunne nå visse resultater, når det gælder klimarelaterede finansielle risici.

--

Hvis relevant står vi gerne til rådighed for yderligere dialog i forhold til ovennævnte. Ellers er det vort håb, at disse betragtninger i sig selv kan bidrage til at sikre, at finansielle virksomheder ledes af tilstrækkeligt egnede og hæderlige personer, også når det gælder håndteringen af klimarelaterede finansielle risici.

Med venlig hilsen
Thomas Meinert Larsen, talsmand AnsvarligFremtid
Lars Jensen Senioranalytiker, VedvarendeEnergi

Bank of England eyeballs the financial sector on climate risk

22 June 2017

Sarah Barker (Special Counsel, Melbourne) and Maged Girgis (Partner, Sydney) analyse the impact of recent regulatory developments on climate change risk management and disclosure for Australian financial services sector participants.

2017 – a step-change in climate risk integration and disclosure?

Even before we have reached its mid-point, 2017 is shaping up as a watershed year for the management and disclosure of financial risks associated with climate change. The first 6 months of this year have seen the following significant developments:

- In January, the World Economic Forum's annual *Global Risks Report* rated four risks associated with climate change ('extreme weather events', 'man-made environmental disasters', 'natural disasters and 'a failure of climate change mitigation and adaptation') within the top 10 risks to the global economy (see here).

- In February, the Australian Prudential Regulation Authority (**APRA**) signalled a significant shift in its position on the relevance of climate change risk to the financial sector. In a speech entitled '*Australia's New Horizon: Climate Change Challenges & Prudential Risk*', APRA Board Member Geoff Summerhayes made clear that all APRA-regulated entities must recognise that climate change has evolved from a 'non-financial' issue to one that presents foreseeable and material financial risks. Moreover, Mr Summerhayes emphasised that a failure to do so may expose directors of asset owners, asset managers, banks and insurers to a claim they have breached their duties (see our Alert here).

- In March, the world's largest investor, BlackRock (with assets under management of US$5.1 trillion) issued its 2017-2018 Engagement Priorities - including **climate risk disclosure** in accordance with the Recommendations of the G20 Financial Stability Board's Bloomberg Taskforce on Climate-related Financial Disclosures(draft recommendations here, with the final recommendations to be presented to the G20 Summit in Hamburg, Germany in July). This was followed by specific guidance on BlackRock's intended engagement with investee companies on climate risk, including a clear warning that it will vote against management – and the re-election of directors - if they fail to constructively engage with this issue (see our Alert here).

- In April, the Australian Senate Economics References Committee issued its report of the Inquiry into Carbon Risk Disclosure in Australia ('*Carbon Risk: A Burning Issue*'). The report included strong recommendations that both the Australian Securities & Investments Commission and ASX provide further guidance to corporations and their directors on the disclosure of the financial risks associated with climate change (here).

- In May, the majority of shareholders in the world's largest listed energy corporation, ExxonMobil, voted *against management* to instead support a resolution requiring the company to assess and disclose the risk to its financial performance and prospects associated with climate change (see for example the Proxy Vote Bulletin issued by BlackRock here).

- And now, in June, the Bank of England Prudential Regulation Authority has released a document entitled '*The Bank of England Response to Climate Change*' (here).

While each of these developments are significant in their own right, the report issued by the Bank of England Prudential Regulation Authority in June is particularly noteworthy.

Bank of England Prudential Regulation Authority announces examination of banking sector climate risk exposures

Following its seminal report into the Impact of Climate Change on the Insurance Sector in September 2015 (here), the Bank of England Prudential Regulation Authority has now served notice of its intention to examine the impacts of climate change on *all* financial sector participants, and to financial stability more broadly. In a report entitled '*The Bank of England Response to Climate Change*' (the **Report**) the Bank emphasized two primary channels by which climate change may impact upon monetary and financial stability:

- **Physical risks** – climate and weather-related events, such as droughts, floods and storms, and sea-level rise. This includes both the direct impacts of such events, and secondary consequences such as the disruption of global supply chains. The Bank warned that these impacts may undermine financial stability, both directly and indirectly – from higher insurance claims, portfolio losses, sentiment shocks and defaults on loans, through to system-wide impacts such as economic disruption, lower productivity, and increasing sovereign default risk.

- **Economic transition risks** - are the financial risks which can result from the process of adjustment towards a lower-carbon economy. The Bank cautioned that changes in climate policy, technology or market sentiment could prompt a reassessment of the value of a large range of assets, and indeed cause sharp changes in valuations (or 'stranded assets'). The speed at which such re-pricing occurs is uncertain but could impact on financial stability via changes to the value of investment portfolios or bank balance sheets through reduced collateral values, or by affecting business models of borrowers. The financial risk from an abrupt transition to a lower-carbon economy may increase if portfolios are not aligned with climate targets. The Bank warned that this implies 'the reallocation of tens of trillions of dollars of investments'.

The Report also noted the Bank's continued monitoring of a second-order risk – that of **litigation** arising from the failure to effectively manage these physical and economic transition risks.

The Report articulated the Bank's dual-track response to these risks:

- first, by firm-level research and engagement in the insurance and banking sectors; and

- second, by working to enhance financial system resilience by supporting an orderly market transition to a low carbon economy. In doing so, the Bank is giving specific emphasis to the Recommendations of the Michael Bloomberg-led taskforce of the G20 Financial Stability Board: the Taskforce on Climate-related Financial Disclosures (above).

How do the cautions from the Bank of England's report resonate in Australia?

The Bank of England's report contains prescient warnings for Australian financial sector participants.

First, 'stranded asset' risk exposure is particularly relevant to an economy whose stock exchange is dominated by companies in the mining, energy and financial services sectors. This was brought into sharp focus by a recent report by S&P Dow Jones, *Barometer of Financial Markets' Carbon Efficiency* (here), that rated the ASX50 as having the greatest stranded asset risk exposure of any major international share index. This comes at a time when Australian banks are already facing pressure on their long-term credit ratings, with agency concerns over the susceptibility of their credit profiles to adverse shock.

Secondly, the Bank of England's report follows an explicit statement of expectation by our own prudential regulator, APRA, that the integration and disclosure of the financial risks associated with climate change is necessary to discharge the duty of due care and diligence by directors of financial services corporations (above).

For these reasons alone, any corporation in the Australian financial services sector should consider the Bank of England's report as part of its broader analysis of climate risks on its financial performance and prospects.

So what to do? Leading international expertise and next steps

So what do these developments mean for the corporate governance, risk management and disclosure in the Australian financial services sector?

In short, it is now beyond doubt that climate change cannot be consigned to a corporate compliance, public relations or 'niche social interest' silo. Its impact on balance sheet items and forward-looking risk and strategy must be reconsidered, in an integrated manner, in the light of contemporary economic realities. This is critical not only for directors, who sign-off on both financial accounts and narrative managerial statements, but accounting and risk advisors.

MinterEllison has been at the forefront of thought leadership in this area and is unique amongst its peers in viewing climate change through a corporations and securities law lens (rather than an 'environmental' lens), for a number of years. Insights from investment market partners, and our work with institutions ranging from the Bank of England and European Union to the UNEP Financial Initiative have provided our financial services clients with tools to efficiently integrate climate risk management into corporate governance and strategy. It is expertise that we would be pleased to share as you consider the practical implications of these developments for your organisation's corporate governance and risk management.

Please do not hesitate to contact Sarah Barker (Special Counsel, Corporate, Melbourne) or Maged Girgis (Partner, Financial Services, Sydney) (below) if we can assist.

Maged Girgis
Partner
Sydney
T +61 2 9921 4410
E maged.girgis@minterellison.com

Sarah Barker
Special Counsel
Melbourne
T +61 3 8608 2168
E sarah.barker@minterellison.com

MinterEllison

MinterEllison

Why is APRA's position on climate change risk all over the papers? And how should we respond?

View as Web Page
Unsubscribe
Forward to a Friend

Dear First Name

As has been heavily covered in the financial press, there has been a significant shift in APRA's position on the relevance of climate change risk to the financial sector. In a recent keynote speech to the Insurance Council of Australia entitled *'Australia's New Horizon: Climate Change Challenges & Prudential Risk'*, Mr Geoff Summerhayes (Executive Board Member of APRA) stated:

- APRA-regulated entities can no longer treat climate change as 'non-financial' issue, or one that will only crystallise in the distant future. Associated risks extend far beyond the physical (ecological) realm to economic transition risks (regulatory, technological and societal). Many of these risks are financial in nature, foreseeable and material – and are actionable now by Australian banks, insurers, asset owners and asset managers.
- In dealing with these risks, '*scenario planning is the new normal*'. Markets and investors increasingly expect corporations to apply a sophisticated and robust approach to modelling of the potential impacts of climate-related risks under different scenarios, and over different time horizons. This includes the sub-2°C transition scenario around which the Paris Agreement (ratified by Australia in November 2016) is anchored. The Recommendations of the G20 Financial Stability Board's Taskforce on Climate-related Financial Disclosures (**TCFD**), released on 14 December 2016, provide clear guidance in this regard.
- A failure to proactively govern the financial risks associated with climate change, now, can present significant litigation exposures for corporations and their directors.

Implications and next steps

Mr Summerhayes' statement is the first by an Australian corporate or prudential regulator to clearly position climate change as a material financial risk. But whilst it may signal a significant shift in domestic prudential practice, in reality it merely more closely aligns our regulatory environment with that of other corporate or prudential regulators, treasuries and stock exchanges around the world.

For a number of years, MinterEllison has been at the forefront of thought leadership in this area and is unique amongst our commercial law peers in viewing the risks associated with climate change as a corporate and securities law (rather than 'environmental') issue. MinterEllison has extensively advised clients institutions from the Bank of England and European Union to the UNEP Financial Initiative across the financial services sector on integrating climate risk management into corporate governance and strategy. It is expertise that we would be pleased to share as you consider the practical implications of this shift in APRA policy for your organisation's corporate governance and risk management.

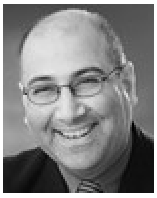
The full transcript of Mr Summerhayes' speech is available here. You will also find below links to a selection of the Alerts that MinterEllison has published on corporate governance issues associated with climate risk in recent years.

(a) Institutional Investment, Corporate Governance and Climate Change: What Is a

Trustee To Do? (available here)
(b) From 'ethical' crusade to financial mainstream: is climate change reaching a tipping point for institutional investors? (here)
(c) Climate change beyond property damage: Prudential Regulation Authority Report emphasises applied risks for the insurance sector (here)
(d) A new COP on the beat – heightened expectations for corporate sustainability governance and disclosure (here)
(e) Straining at the Floodgates – International Developments in Climate Risk Disclosure & Litigation (here)

We have also prepared a briefing paper on APRA's new approach to climate risk governance that you may find useful to circulate to your board and executives. We would be pleased to provide that briefing paper upon your request. Please do not hesitate to contact us if we can assist.

Sarah Barker
Special Counsel
T +61 3 8608 2928
email me | read my bio



Maged Girgis
Partner
T +61 2 9921 4410
email me | read my bio

MinterEllison

Be Informed . Publications

Institutional investment, corporate governance and climate change: what is a trustee to do?

27 January 2015

Recent publicity surrounding the exclusion or divestiture of stocks in carbon-intensive industries shows that leading investors are reviewing the financial risks (and opportunities) associated with climate change. However, with debate on climate change often pitched around ideological poles, many superannuation fund trustees are struggling to translate these developments into prudent governance practice, consistent with their statutory and general law duties. This article looks beyond the political debate to consider what recent developments on climate change mean for the legal obligations of fund trustees, and the implications for boardroom practice. In doing so, they note that focus on the outcomes of investment (or divestment) decisions may have obscured the key legal issue – that of diligent process.

Change is occurring, in two contexts: science and economics

Institutional stakeholder viewpoint

The relationship between climate change issues and financial wealth continues to rapidly, and radically, evolve.

Historically, climate change was often regarded as an ethical issue for investors – a 'non-financial environmental externality' that was secondary to, and largely inconsistent with, the investment imperative to maximise financial returns.

Over the past decade, more funds have applied an integrated Environmental, Social and Governance (ESG) approach in which 'responsible' investment practices have been applied to generate both positive external outcomes and benchmark financial returns.

More recently, however, the financial risks and opportunities presented by climate change have become a mainstream issue for the investment community. Debates over 'stranded asset' exposures (eg the IMF, OECD, WorldBank)and asset divestitures play out in the financial press. Recognised economic and financial institutions warn of the significant economic consequences of climate change. And, globally, we are witnessing a surge in political and regulatory interventions in an attempt to deal with climate change and the resulting community concerns.

These developments illustrate that, increasingly, market stakeholders view the financial risks (and opportunities) associated with climate change as extending beyond its potential physical impacts, toencompass market, reputational and legal issues, such as:

- community and reputational risk which can quickly and significantly affect investment value (take for example, the speed and impact of the anti-coal seam gas campaign in NSW)
- litigation against investee companies for first or third party damage (eg. damage to third parties due to a firm's failure to adapt to climate change risks, or damage to company itself via shareholder derivative action due to cost/loss of value from the failure to adapt)
- new laws or policy developments that may result in rapid re-pricing of assets (eg. intergovernmental agreements on emissions restrictions)
- closure or restriction of markets (eg. Chinese Government's tariff on Australian thermal and coking coal (later revoked upon settlement of the FTA))

Contacts

Maged Girgis

Sarah Barker

Related Services

Corporate

Competition and Market Regulation

Funds Management

Superannuation

Related Industries

Financial Services

- technology quickly developing towards lower carbon emissions (eg. developments in battery storage technology, rapid uptake of distributed energy solutions – particularly in emerging markets, rapid uptake of electric vehicles)
- relative cost competitiveness between fossil and renewable energy sources
- oil and gas price fluctuations (eg. high prices impacting on the relative cost competitiveness of alternatives such as electric vehicles, low prices reducing the viability of capex on unconventional fossil fuel reserves such as oil tar sands, shale fracking)
- inaccurate business modelling of medium to long term projects (eg. unrealistically low internal price on carbon)
- maladaptive short-term strategies, ie. investments that may deliver short-term economic gains but exacerbate vulnerability to potential climate change related issues in the medium-long term (eg. locking in capital-intensive infrastructure in a carbon-intensive business, ignoring 'stranded asset' risks)
- exploiting opportunities to increase market value across asset classes (eg. active engagement with investee companies around climate change exposures and strategies, recognition of market value perceptions around energy-efficiency for real estate / infrastructure, lower costs of capital and insurance).

Many of these factors are driven by evolving societal, governmental and market perceptions which go beyond the potential physical impacts of climate change. However, irrespective of their source, these factors present both material financial risks and opportunities, which must be actively considered in the pursuit of wealth-based interests.

Developments in governance law

The last few years have also seen the legislature, regulators and the courts hold directors and trustees to higher standards of professionalism and pro-activity to satisfy their duties of due care, skill and diligence.

The *Superannuation Industry Supervision Act* now holds trustees to the standard of the 'prudent superannuation trustee' rather than merely the 'ordinary prudent person'. Further, APRA, ASIC and the ASX continue to revise their guidance on expected standards of governance. Finally, findings against directors in cases such as Centro and James Hardie have reinforced the courts' view that 'due care and diligence' requires directors to be both informed and engaged, and to actively monitor corporate implementation of strategic plans and policies.

Together, these developments have the potential to significantly impact the way in which trustees and their directors approach the governance of their funds. Regardless of a trustee's personal, moral or ideological views on the reality of climate change, it simply cannot ignore the financial risks associated with the issue discussed above.

But does this mean that a trustee is now duty-bound to ensure that asset valuations consider these financial risks? Are they already reflected in market price valuations? Are the relevant risks measurable with sufficient certainty? Should funds exit from investments in exposed sectors, or is that an over-reaction? What does it mean for competing pressures around risk tolerance, value growth, dividend yield, liquidity and diversification? When is it 'material'? And is it really an issue for trustee boards at all, or one that should be left for their consultants and investment managers?

What do these developments mean for trustees in practice?

Fiduciary duties

In short, the sharp evolution in the relationship between climate change and financial wealth suggests that, as with any material financial risk, an inactive, reactive or passive approach to its governance may be inadequate to discharge a trustee's duties of due care and diligence in pursuit of the best interests of fund beneficiaries.

It is the *process* of information gathering and deliberation that is critical to satifying the duty of due care and diligence. The decision that results from that process, to divest or not to divest, or to exclude or not to exclude, is not the determinative issue. Rather, the relevant inquiry is whether, in their oversight of fund performance against its objectives, a trustee is appropriately informed and engaged with relevant risks and opportunities, has sought expert advice where appropriate, has applied independent judgment to the matters at hand, and has constructively evaluated the strategic consequences of material issues using methodologies and assumptions that are appropriate for their forward-looking purpose.

So what does this mean in the context of climate change issues and the fossil fuel divestiture debate? It is not to say that trustees are duty-bound to decarbonise their portfolios, or that environmental sustainability must be universally prioritised. Nor does it suggest that trustees of 'open' funds must reconsider the nature of their fund beneficiaries' collective 'best interests' and extend them to incorporate external, ethical, moral or ideological goals. But it does mean that boards must actively engage with the impact of these financial risks and opportunities on their portfolios.

On the one hand, a knee-jerk, blanket directive to exclude mining, resource or utility companies from the investment universe may fall short of minimum standards of diligence. On the other, so may a governance approach that is entrenched in the denial or ignorance of the financial risks and opportunities associated with climate change, or a 'strategic management' approach that such risks do not require action without regulatory direction.

In practice, there is simply no substitute for trustee engagement with and evaluation of any economic or strategic issues that may materially affect the performance of their fund. As demonstrated by recent developments, climate change is increasingly becoming one such issue.

Misleading disclosure and reporting

Risks or opportunities associated with climate change also present challenges for disclosure and reporting obligations. Trustees must ensure that their investment practices continue to accurately reflect the fund's stated beliefs, objectives and public commitments.

There is a growing disconnect between ideological commitments to 'sustainability' and the investment strategies required to implement them. Over-statement of the 'responsible' characteristics of an investment option or policy, or ineffectual policy implementation, may expose the trustee and directors to claims that they have misled their fund beneficiaries or the market.

Trustees are required to consider not only whether their Statement of Investment Beliefs recognises the risks or opportunities of climate change, but also how these beliefs are implemented. Are they reflected in investment policies, strategies, mandates, incentive structures and practices? What performance metrics are applied, measured and evaluated? And how does management, and in turn the board, monitor processes and performance on point?

A starting point for diligent governance

Many trustees are overwhelmed by the scale and complexity of the governance challenge at hand. To simplify the process, a number of preliminary questions can be asked. The following list is not intended to cover all aspects of risk under the trustee and directors' duties and related obligations, or as a replacement for legal advice in a particular context. However, trustees may find it useful as a ready reference.

- Have your **trustee board, General Counsel and Company Secretary** received specific training on their **statutory and fiduciary duties** in the light of recent legislative updates and Court decisions?
- Do your trustee **board, General Counsel, CIO, asset/fund managers, analysts and consultants** receive up-to-date, specific and appropriately-qualified briefings on the financial risks associated with climate change?
- Has a review been conducted on **current portfolio exposures** to climate change risks including emissions profiles and stranded asset risks?
- Does your **Statement of Investment Beliefs** include a recognition of financial risks or opportunities associated with climate change? How are those Investment Beliefs, or any other public commitments around environmental sustainability, **implemented**? How are they reflected in investment policies, mandates, incentive structures and practices? What hedging options are available? What are the different implications across fixed income, equities and direct ownership asset classes? What valuation and performance metrics are applied, measured and evaluated? And how does the board monitor processes and performance on point?

- What does your trustees' **Directors' & Officers' Insurance** policy cover, and exclude, in the context of governance failures around climate change risks and opportunities?

Author(s) Maged Girgis, Sarah Barker

From 'ethical crusade' to financial mainstream – is climate change reaching a tipping point for institutional investors?

22 JUNE 2015

Sarah Barker (Special Counsel, Melbourne) and Maged Girgis (Partner, Sydney) report on international developments that are raising the bar on climate change investment risk management.

Fossil fuel exclusions and financial best interests

The issue of 'fossil fuel divestiture' continues to noisily occupy column space in the financial press. Confined by word limits, the debate on point is often simplistic and polar – presented as a binary choice between maximising financial returns, and the environmental ethics of investing in sectors with a significant carbon footprint (primarily through the combustion of fossil fuels).

Consistent with the binary positioning of the debate, the divestment or exclusion of fossil fuel-related assets by institutional investors has largely been explained by reference to 'moral' or 'ethical' grounds. For philanthropic foundations and private endowments (such as the high-profile Rockefeller Foundation), and faith-based or educational institutions (such as the Uniting Church in Australia, Stanford and Oxford Universities) – a decision whether to divest or otherwise can be relatively straightforward, as the interests of their stakeholders are more readily ascertainable. In contrast, open industry, retail and corporate funds and retail investment houses would have difficulty substantiating an 'ethically-based' divestment or exclusion in the absence of a clear mandate in the fund's governing rules or direction from the member corpus, as this may conflict with obligations to prioritise financial interests.

The potential conflict has been steadily eroded in recent times, with the recognition of the material financial risks (and opportunities) associated with climate change. Leading mainstream brokers and advisers such as Citi, Towers Watson, HSBC and Mercer have published reports recognising the risk of fossil fuel asset 'stranding' due to shifts in emissions regulation and renewables technologies. Industry funds including HESTA ($29 billion under management – see here) and Local Government Super ($7.4 billion under management – see here) have announced policies to negatively screen investments in thermal coal (and, for LGS, other 'high carbon sensitive' activities such as tar sands mining and coal-fired electricity generators) based on the best *financial* interests of members. However, no retail or sovereign wealth funds have followed suit. Until now.

Last week, the world's largest sovereign wealth fund, the US$902 billion Norwegian Government Pension Fund Global, announced that it would divest or exclude investments in companies '*who* *themselves or through other operations [that] they control base 30% or more of their activities on coal, and/or derive 30% of their revenues from coal*' (see here). Similarly, French insurance giant AXA announced that it would exclude *'mining companies deriving over 50% of their turnover from coal mining and electric utilities deriving over 50% of their energy from thermal coal plants*' (see here). These exclusions policies represent a significant inflection point in the 'fossil fuel divestiture' debate, with both funds making an express link between climate change and their *financial* risk/returns.

Beyond 'divestiture' – new norms of engagement

The examples set by AXA and the Norwegians do not mean that, overnight, funds should adopt a herd mentality to divest or exclude assets in carbon-intensive industries. Any such knee-jerk reaction would itself be inconsistent with trustees' fiduciary duties. Such a complex issue demands diligent consideration of both portfolio impacts and treatments (from asset allocations to sectoral tilts, engagement, hedging and beyond). Many institutional investors have in fact determined, upon due deliberation, that it is *not* in their beneficiaries' best financial interests to divest from or exclude fossil fuel assets. Often, funds prefer to keep 'a seat at the table', and engage with investee companies on the relevant commercial risks and opportunities.

However, a decision to 'engage' cannot be seen as a passive strategy. The bar on 'active ownership' by mainstream investors is being raised, with leading funds have been increasing pressure on both investee companies and asset managers to proactively manage climate change risks. For example:

- In the current northern hemisphere reporting season, asset owners are engaging with portfolio companies on the topic of climate change at unprecedented rates. More and more, general corporate assurances around 'sustainability', and plans to incrementally reduce operational emissions, are failing to satisfy investor demands. A proactive, substantive approach to climate risk governance is increasingly required – with evidence that its implications for medium-long term strategy have been duly considered and meaningfully disclosed. It is important to remember that this is not just from 'ethical' shareholder activists, but also from mainstream institutional investors whose concerns remain squarely centred on risk and return. In April and May, special shareholder resolutions were passed at the AGMs of oil giants Shell, BP and Statoil requiring them to stress test their forward strategies against potential climate change futures endorsed by the International Energy Agency. Notably, these resolutions were passed with a resounding majority of 98.3, 99.8 and 99.9% of the shareholder vote, respectively. In each case, less than 3.5% of votes were withheld.
- In the United States, a letter co-signed by more than 60 large institutional investors (representing USD1.9 trillion in assets under management) has been sent to the Chair and Commissioners of the Securities & Exchange Commission (**SEC**) (see here). The letter expresses concern that '*oil and gas companies are not disclosing sufficient information*' about '*carbon asset risks*'[1] in their statutory filings with the SEC and requests the SEC to address these deficiencies in direct correspondence with the filing companies.
- In addition to the divestiture actions discussed above, in recent months two of the world's largest institutional investors, the Norwegian sovereign wealth fund and US$305 billion Californian pension fund CalPERS, have announced statements of expectation for portfolio companies

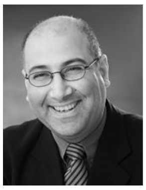
[1] These risks include, but are not limited to, the risk of capital expenditures on high cost 'unconventional' oil and gas projects, increasing global regulation of carbon emissions, and the possibility of reduced global demand for oil in the medium term.

(Norway) and external investment managers (CalPERS) on the integration of climate change issues into standard financial risk assessment processes.

Conclusion

There is significant momentum behind the recognition of the financial risks and opportunities associated with climate change over current investment horizons. This momentum is not driven only by 'ethical' shareholder groups but also by leading mainstream institutions who are proactively engaging with these associated valuation, risk management and disclosure issues. Arguably, this represents a tipping point that trustees would be ill-advised to ignore.

June 2015



Maged Girgis
Partner
Sydney
T +61 2 9921 4410
E maged.girgis@minterellison.com

Sarah Barker
Special Counsel
Melbourne
T +61 3 8608 2168
E sarah.barker@minterellison.com

Minter Ellison Offices

AUSTRALIA

BRISBANE LEVEL 22 WATERFRONT PLACE 1 EAGLE STREET BRISBANE QLD 4000 • T +61 7 3119 6000

CANBERRA LEVEL 3 MINTER ELLISON BUILDING 25 NATIONAL CIRCUIT FORREST CANBERRA ACT 2603 • T +61 2 6225 3000

MELBOURNE LEVEL 23 RIALTO TOWERS 525 COLLINS STREET MELBOURNE VIC 3000 •T + 61 3 8608 2000

PERTH LEVEL 4 ALLENDALE SQUARE 77 ST GEORGES TERRACE PERTH WA 6000 • T +61 8 6189 7800

SYDNEY LEVEL 40 GOVERNOR MACQUARIE TOWER 1 FARRER PLACE SYDNEY NSW 2000 • T +61 2 9921 8888

ASIA

BEIJING UNIT 1022 LEVEL 10 CHINA WORLD TOWER ONE 1 JIANGUOMENWAI AVENUE BEIJING 100004
PEOPLE'S REPUBLIC OF CHINA • T +86 10 6535 3400

HONG KONG LEVEL 25 ONE PACIFIC PLACE 88 QUEENSWAY HONG KONG SAR • T +852 2841 6888

SHANGHAI SUITE 4006-4007 40th FLOOR CITIC SQUARE 1168 NANJING ROAD WEST SHANGHAI 200041
PEOPLE'S REPUBLIC OF CHINA • T +86 21 2223 1000

ULAANBAATAR SUITE 612, CENTRAL TOWER, GREAT CHINGGIS KHAAN'S SQUARE 2, SUKHBAATAR DISTRICT 8, ULAANBAATAR 14200
MONGOLIA • T +976 7700 7780

UK

LONDON 10 DOMINION STREET LONDON EC2M 2EE • T +44 20 7448 4800

Minter Ellison Legal Group Associated Offices

AUSTRALIA

ADELAIDE LEVEL 10 GRENFELL CENTRE 25 GRENFELL STREET ADELAIDE SA 5000 • T +61 8 8233 5555

DARWIN LEVEL 1 60 SMITH STREET DARWIN NT 0800 • T +61 8 8901 5900

GOLD COAST GROUND FLOOR 165 VARSITY PARADE VARSITY LAKES QLD 4227 • T +61 7 5553 9400

NZ

AUCKLAND MINTER ELLISON RUDD WATTS LEVEL 20 LUMLEY CENTRE 88 SHORTLAND STREET AUCKLAND 1010 • T +64 9 353 9700

WELLINGTON MINTER ELLISON RUDD WATTS LEVEL 17 125 THE TERRACE WELLINGTON 6140 • T +64 4 498 5000

www.minterellison.com

MinterEllison

Alert – Climate change beyond property damage: Prudential Regulation Authority report emphasises applied risks for the insurance sector

11 November 2015

The recent Bank of England Prudential Regulation Authority's report, 'Implications of Climate Change for the Insurance Sector', highlights two categories of risk that have received little attention to date – but which have significant potential implications for investment and general underwriting activities.

There has been significant commentary in the financial press about the Bank of England Prudential Regulatory Authority (**PRA**)'s report *on The Impact of Climate Change on the UK Insurance Sector* (**Report**), launched by Bank Governor Mark Carney at Lloyds of London on 29 September.

The Report represents a strong warning by the UK's prudential regulator on the significant potential impacts of climate change on both the investment and general underwriting activities of insurers, and on the stability of the financial system more broadly. Whilst it purports to provide 'an initial risk assessment' for the UK US$2 trillion financial services sector, its implications are likely to resonate across what is a globalised industry.

Beyond the physical

The Report identifies three broad channels of systemic risk for the insurance sector associated with climate change – **physical** risks, **transition** risks and **liability** risks – which it warns '*present a substantial challenge to the business model of insurers*'.[1]

The majority of the analysis focuses on the physical risks, which the PRA classifies as '*first-order risks which arise from weather-related events, such as floods and storms. They comprise impacts directly resulting from such events, such as damage to property, and also those that may arise indirectly through subsequent events, such as disruption of global supply chains or resource scarcity.*'[2] Such physical risks tend to be well-understood by Australian general insurers, who face regular underwriting exposures from extreme weather events such as bushfires, floods and storms.

The other risk channels identified in the Report – transition and liability risks – reflect the rapid evolution of climate change into a significant financial risk, with systemic impacts across the global economy far beyond direct physical damage. These risks are extremely significant for both investment and general underwriting activities. However, they have received little attention within the Australian insurance sector to date. So what are these 'under-considered' risks, and what are their key implications for Australian institutions?

Transition Risks

The PRA classifies financial 'transition' risks as those which could arise from the global economy's inexorable transformation to a lower-carbon norm. The Report notes:

---

[1] PRA Report, page 5.
[2] PRA Report, page 4.

> *The Intergovernmental Panel on Climate Change (IPCC) estimates that maintaining a greater than 66% probability of keeping human-induced warming within the globally agreed goal of 2°C would require total global carbon emissions from 2011 onwards to be less than around 1,000 GtCO2. Keeping within this '2°C carbon budget' would require a significant shift in the trajectory of carbon emissions – at current rates, the entire budget would be fully used within the next 25 years.*[3]

The Report explains that the transition risks for insurance firms primarily relate to 'stranded assets' in their investment portfolios – '*the potential re-pricing of carbon-intensive financial assets, and the speed at which any such re-pricing might occur*.' Such assets include the equities and bonds of both '*firms that may be impacted directly by regulatory limits on their ability to produce or use fossil fuels, ([including] coal, oil and gas extraction companies, and conventional utilities)*', and those with energy-intensive operations that may be significantly impacted by any increase in energy costs (including those in the *'chemicals, forestry and paper, metals and mining, construction and industrial production'* sectors).[4]

It is important to note that the portfolio transition risks identified in the Report are conceptually distinct from those arising from recent high-profile 'fossil fuel divestment' campaigns. The latter campaigns have prompted many faith-based, educational and private endowments to exclude investments in companies with carbon-intensive operations or outputs from their portfolios – based primarily on ethical, environmental grounds. In contrast, the Bank of England analyses the risks associated with climate change through a singularly economic lens, emphasising the need to manage the portfolio risks of a potentially rapid re-pricing of carbon-intensive assets. The PRA's approach echoes that increasingly adopted by leading international institutions, such as the Norwegian sovereign wealth fund, French insurance giant AXA and superannuation funds such as HESTA, LGS, Calprs and Calstrs, who have all recently committed to divesting from carbon-intensive equities on squarely financial grounds.

The economic risks (and opportunities) associated with climate change continue to rapidly – and radically – evolve. Many corporations and their investor asset owners still struggle to conceive climate change as a material financial issue, rather than a non-financial environmental externality. The PRA Report provides an unequivocal message that a failure to respond to the dynamic financial risk landscape presents a serious risk to their firms. It reflects the view that a proactive, substantive approach to climate risk governance is increasingly required – with evidence that its implications for medium-long term strategy have been duly considered and meaningfully disclosed. And it goes even further – to suggest that a failure to do so is potentially actionable.

Liability risks

The last risk channel identified in the Bank of England's Report is that of **liability risks**, in the form of increased liability exposure under third-party liability policies such as professional indemnity and directors' and officers' insurance. Such risks '*arise from [third] parties who have suffered loss and damage from the physical or transition risks from climate change seeking to recover losses from others [the insured] who they believe may have been responsible.*'[5]

This category of risk has received the least attention in the weeks following the release of the Bank's Report. It may, however, prove to be the most significant, given its low profile within the Australian insurance industry to date.

The Report identifies the potential for third-party liability claims against insured entities in three broad categories:

a. **failure to mitigate** – claims alleging that *'insured parties are responsible for the physical impacts of climate change, for example through emissions of greenhouse gases, and therefore can be held directly liable for loss or damage to third parties'*;

b. **failure to adapt** – claims alleging that *'insured parties have not sufficiently accounted for climate change risk factors in their acts, omissions or decision-making. In principle, this could apply to a range of climate change-related risk factors, not just those from physical risks such as storms and*

---

[3] PRA Report, page 7.
[4] PRA Report, page 7.
[5] PRA Report, page 57.

floods, but the governance of economic or financial issues that are material to corporate risk or return.' The PRA emphasises that such claims may be formulated under prevailing corporate and/or tort laws;

c. **failure to disclose or comply** – claims alleging that insured parties '*have not sufficiently disclosed information relevant to climate change, have done so in a manner that is misleading, or have otherwise not complied with climate change-related legislation or regulation*.' The Report suggests that this may be 'one of the quickest' categories of claim to evolve.[6] This has indeed been borne out in international regulatory activity following the publication of the PRA's report. Perhaps most significantly, in November 2015 the New York Attorney-General announced that it was investigating whether a number of corporations in the energy and resources sector had made misleading disclosures concerning climate change risks and their potential impacts on the companies' businesses. These investigations have led to settlements (under an Assurance of Discontinuance) being reached with at least one corporation listed on the NYSE, under which the corporation agreed to modify its disclosures going forwards.

The Report concludes that:

> *'The PRA views legal liability risks from climate change as an area that may evolve adversely; firms are encouraged to consider all aspects of this risk and be forward-looking in their approach.'*[7]

Further action

Minter Ellison has been at the forefront of thought leadership on climate change liability risks. Our cross-divisional reports on fiduciary liability exposures for inaction on risks associated with climate change (such as *Institutional investment, corporate governance and climate change: what is a trustee to do?; From 'ethical' crusade to financial mainstream: is climate change reaching a tipping point for institutional investors?; and The first class action salvo? Breach of duty claim filed against fiduciary trustees of coal company pension fund*) have been nationally and internationally recognised. We would be delighted to share these leading publications with you upon request.

A full copy of the Bank of England's Report is available here. For further analysis of the technical aspects of the report and its particular ramifications for the Australian financial services and insurance sector, please contact Sarah Barker.

[6] PRA Report, page 59.
[7] PRA Report, page 64.

MinterEllison

A new COP on the beat – heightened expectations for corporate sustainability governance and disclosure

June 2016

Sarah Barker *(Special Counsel, Melbourne) and* ***Maged Girgis*** *(Partner, Sydney) examine international developments that are raising the bar on corporate governance, and disclosure of, risks and opportunities associated with climate change.*

Background – economic and regulatory evolution

You may have noticed a subtle change in the emphasis of your morning coffee read. The financial press has begun to devote serious column space to the issue of 'climate change'. So why this mainstream interest on what was, historically, an issue consigned to the 'environmental fringe'?

In short, leading market stakeholders have begun to recognise that issues associated with climate change present significant economic and financial risks (and opportunities) over both long- and shorter-term investment horizons, which cannot be ignored.

Such risks and opportunities arise not only from the physical impacts of climate change (which include an increase in extreme weather events, and 'gradual onset' impacts such as the increase in global average temperatures, rising sea levels due to water expansion and ice melt, and alteration of regional precipitation patterns), but associated regulatory, technological and societal responses.

This was recently underscored by the World Economic Forum in its *2016 Global Risks Report*, in which *'A failure of climate change mitigation and adaptation'* was rated as having *the top impact* of all current risks to the global economy.

The Paris Agreement settled at the Conference of Parties **(COP)** on 12 December 2015 has been recognised as a strong signal of the direction of market travel. The significance of that Agreement should not be underestimated. It represents a commitment by the Governments of 196 signatory countries to a goal of limiting the '*increase in the global average temperature to well below 2 °C above pre-industrial levels*' and to pursue ' *efforts to limit the temperature increase to 1.5 °C above pre-industrial levels*'. And, perhaps most significantly, a commitment by those governments to shift the global economy to an emissions platform of *net zero* by the middle of this century.

In order to meet the Paris goals, each country will need to significantly reduce its 'business as usual' emissions and the global economy, which has been heavily reliant on fossil fuel combustion since the industrial revolution, will need to transform, at scale and with speed.[1] The impacts are likely to be felt across all asset classes and industrial sectors, but in particular by carbon-intensive industries.

As a result, the corporate regulatory landscape – from reporting regulations to litigation trends - is now shifting to keep up with these developments. So what exactly does this suggest for corporate governance and disclosure in Australia?

Policy & regulatory reform – corporate disclosure

Historically, the inherent uncertainty in the scope, distribution and timing of the future impacts of climate change have led many corporations to disclose relevant risks via broad, high level or boilerplate

[1] See for example European Commission, COM(2016) 110 Final, Brussels 3 February 2016.

MinterEllison

language. Such disclosures are rarely decision-useful for investors, and are increasingly recognised as potentially presenting a misleading picture of a company's financial position.

To this end, regulators and private litigants have begun to demand that climate change-related disclosures are both specific to the performance indicator on which they may impact, and to account for uncertainty via stress-testing across the range of plausible climate futures.

Internationally, regulators are increasingly issuing specific (and often binding) guidance on the disclosures. For example:

- On 1 April 2016, the Taskforce on Climate-Related Financial Disclosure (Chaired by Michael Bloomberg) released its *Phase I Report and Public Consultation*. The Taskforce has been tasked by the G20 Financial Stability Board to assess what constitutes effective and efficient disclosure of climate-related issues, to:

  (a) support informed investment credit and insurance-underwriting decisions about reporting companies; and

  (b) enable a variety of stakeholders to understand the concentration of carbon-related assets in the financial sector and the financial system's exposure to climate –related risk.

  The Phase I Report specifically identifies the need for disclosures pertaining to the near-, medium- and long-term impacts of climate-related financial risks by all actors in the investment supply chain, from corporations to asset owners. The Taskforce is due to provide its final report by the end of 2016. Whilst its recommendations are 'voluntary', they are likely to set a baseline for international disclosure expectations;

- From 1 January 2016, under the French *Energy & Ecology Transition Law*[2], all French asset managers, insurers and pension funds must report on how they integrate 'environmental, social and governance' (**ESG**) issues into their investment processes. The French Treasury's *Implementation Decree* prescribes the information that must be included in that report – including:

  - engagement policies (and assessment of their implementation) and methodologies applied in the companies' analysis of climate risk and its results; and
  - specific information regarding the projected impacts of (amongst other things):
    - changes in the availability and price of natural resources and the consistency of their exploitation with climate and environmental goals;
    - the coherence of capital expenditure issues with low carbon strategies, and in particular for actors involved in the development of fossil fuel resources, the underlying hypothesis supporting such expenditures;
    - any policy risk related to the implementation of domestic and international climate targets; and
    - measures of past, current or future greenhouse gas emissions directly or indirectly associated with emitters included in the investment portfolio, including the way the measure is used for risk analysis;[3] and

- In October 2015, the World Federation of Exchanges (the peak association of international stock exchanges, of which the ASX is a member) issued its *Model Guidance on Reporting ESG Information to Investors – A Voluntary Tool for Stock Exchanges to Guide Issuers*. The Guidance identifies 34 ESG metrics that should be included in reports of listed entities as material drivers of financial performance. These include 10 metrics that are directly referable to issues associated with climate change, including direct and indirect GHG emissions and carbon intensity (emissions relative to revenue). More than 20 of the Federation's 64 international exchanges have already incorporated the Model Guidance into their exchange rules.

These international regulatory developments do not of course comprise 'the law' in Australia. However, they certainly indicate the direction of travel of our own governance and disclosure laws. These developments are also likely to influence both our regulators and, in the event of litigation in relation to corporate disclosure, the courts.

Corporations would be well-advised to have regard to these trends, now, to minimise regulatory – and litigator – scrutiny in that shift .

---

[2] See Article 173-VI.

[3] Based on the (unofficial) English translation of the Implementation Decree by the *2° Investing Initiative* available here.

Prevailing 'general' disclosure laws – litigation

Even in the absence of specific 'climate change risk reporting' guidance, allegations of misleading disclosure of risks associated with climate change are being increasingly interrogated under prevailing 'general' disclosure laws. For example:

- On 4 November 2015, the New York Attorney-General issued a subpoena to oil producer ExxonMobil as part of an investigation into whether its regulatory filings had misrepresented the financial risks to their business from climate change.[4] By April 2016, more than 20 US-State Attorneys-General had joined this investigation.
- On 9 November, the Attorney-General announced the resolution of similar investigations into Peabody Energy. The Attorney-General determined that Peabody had contravened State misleading disclosure laws[5] by filing annual reports that mis-represented the potential impact of emissions regulations on its business, and selectively disclosing only favourable International Energy Agency energy and fuel-mix projections from a range of scenarios.[6] The Attorney-General's investigation was settled pursuant to an 'Assurance of Discontinuance', in which Peabody Energy did not admit or deny the allegations of breach.

These claims, whilst untested before the courts, provide a stark demonstration of the potential capacity of prevailing corporations and securities laws to apply in relation to corporate governance and disclosure of risks associated with climate change. In particular, they evidence a growing recognition that issues associated with climate change can give rise to material financial risks and opportunities – of such breadth and significance that failure to properly disclose them to the market warrants regulatory intervention.

This is not to say that risks associated with climate change will be material to *every* corporation in every context. However, given the broader financial market recognition of climate change as a material driver of financial risk, it is increasingly difficult for a company Board to *presume* that climate change will not have a material impact on the company's business.

Any such conclusion must be supported by a robust process of assessment in the circumstances of the company. Directors are expected to apply due care and diligence to this task – to appropriately educate themselves as to relevant issues, proactively inquire where information is lacking or contradictory, continually monitor and reconsider material issues in the face of evolving market conditions, and to actively apply independent judgment in a critical evaluation of relevant matters. For business strategy and performance projections, in particular, a default to historical norms on climate change are simply incapable of accurately conveying prospective market risk/return.

Shareholder activism – but not as you know it

Where corporations have been slow to recognise the potential significance of climate-related financial exposures, they are increasingly subject to 'forceful stewardship' by institutional investors.

Over the last few years, there has been a significant increase in shareholder activism on corporate disclosure of climate change risks: not only by 'activist shareholders' seeking to advance their external agendas, but mainstream, institutional investors with a genuine demand for decision-useful information on what they consider to be a material financial risk issue.

In some of the most high profile examples, in 2015 special shareholder resolutions were passed by oil giants Shell, BP and Statoil requiring them to stress test their forward strategies against potential climate change futures endorsed by the International Energy Agency. These resolutions *were* both supported by the board and passed at the companies' AGMs – with a resounding majority of 98.3, 99.8 and 99.9% of the shareholder vote, respectively. Similar resolutions were passed, again by significant majorities, at the 2016 AGM's of multi-national resource companies such as Anglo American, Rio Tinto and Glencore.

However, this is not only a European phenomenon. The US Securities & Exchange Commission recently refused a petition by the boards of ExxonMobil and Chevron to keep similar resolutions off the ballots at their AGM's on 25 May.

---

[4] ExxonMobil, 'ExxonMobil to Hold Media Call on New York Attorney General Subpoena' (News release, 5 November 2015).
[5] Article 23-A, Section 352 *et seq*. of the New York General Business Law (the '*Martin Act*') and Section 63(12) of the New York Executive Law.
[6] Attorney General of the State of New York Environmental and Investor Protection Bureaus, *In the Matter of Investigation by Eric T Schneiderman, Attorney General of the State of New York of Peabody Energy Corporation, Respondent*, Assurance 15-242.

The resolutions failed to attract the support of either management or a majority of shareholders. However, each *was* supported with an unprecedented 38 and 41% (respectively) of the vote. Supporters included institutional heavyweights with more than US$10 trillion in total assets under management, such as the Norwegian Sovereign Wealth Fund, the New York State Common Retirement Fund, Calpers and Hermes Equity Services. The Wall Street Journal characterised the vote as: "*an indication that more mainstream shareholders like pension funds, sovereign-wealth funds and asset managers are starting to take more seriously the threat of a global weaning from fossil fuels.*"[7]

Closer to home, shareholders have also begun to file climate risk-focused resolutions with companies listed (or dually listed) in Australia, particularly in the resources (BHP and Rio Tinto) and financial services (CBA, ANZ) sectors. Although the Rio Tinto resolution, tabled in its dual 2016 AGM's in April (London) and May (Brisbane), is the only one to have passed, the other resolutions have been influential in prompting corporations to disclosure further detail around their recognition and management of risks associated with climate change. This has the effect of raising the disclosure bar for other corporations in their sectors, as investors seek comparable, decision-useful information.

Getting started: five priority areas for director focus

So what can directors and senior executives do *in practice* in the face of the complex issues associated with climate change? We suggest below a set of questions that may be a useful starting point for interrogation of this issue:

1. What are the risk (and opportunity) drivers to our business associated with climate change? Look beyond direct greenhouse emissions to susceptibility to physical impacts including extreme weather events (both for plant, infrastructure and supply chains), water scarcity, heat stress, drought etc; transition risks (including reputational and stranded asset and commodity price risks); and liability risks.
2. What are the potential financial impacts of these drivers under a range of plausible climate change scenarios, in the short, medium and longer term? Consider: what stress-testing do we conduct under what climate scenarios? What actions are we taking to manage and mitigate these risks, and to develop resilience in our operations? How are these risks integrated into our strategic planning assumptions, commercial hurdle rates and risk management frameworks?
3. What does our business model look like in a net zero economy? What is our transition plan, over what time frame?
4. What analysis has been performed, and by whom? How does the board oversee climate risk management?
5. What statements do we make about future growth and business plans – in our annual reports or broader market statements? On what assumptions are these predictions based? Would they be materially impacted under any plausible climate scenario? If so, how do our disclosures note this?

Whilst the above list is necessarily high-level and general, we would be pleased to provide specific advice on those governance steps likely to satisfy a director's duty of due care and diligence in their corporation's unique context.

Minter Ellison has been at the forefront of international thought leadership on the implications of climate change for corporate governance, insurance, institutional investment and disclosure. We would be delighted to share other recent Client Alerts on point with you upon request. Please contact ***Sarah Barker*** and ***Maged Girgis.***

[7] Bradley Olsen and Nicole Freeman, ' Exxon, Chevron Shareholders Narrowly Reject Climate-Change Stress Tests', *Wall Street Journal*, 25 May 2016.

MinterEllison

Straining at the floodgates – international developments in climate risk disclosure and litigation

November 2016

> [D]evelopment of the common law, as a response to changed conditions, does not come like a bolt out of a clear sky. Invariably the clouds gather first, often from different quarters, indicating with increasing obviousness what is coming.
>
> *Lord Justice Nicholls, Re Spectrum Plus Ltd (in liq) [2005] 2 AC 680, [33]*

In our recent Alert *A New COP on the Beat – Heightened Expectations for Corporate Sustainability Governance & Disclosure* (available here) we examined international developments raising the bar on corporate governance and disclosure of financial risks associated with climate change. These regulatory signals continue to solidify.

In this Alert, **Sarah Barker** (Special Counsel) and **Maged Girgis** (Partner) discuss a number of notable regulatory investigations in Europe and the United States, and consider what they suggest for the direction of corporate regulation – and litigation – in Australia.

Standard securities laws applied to dynamic economic realities

In recent months, international regulators have continued their application of 'general' securities laws to the disclosure of climate-related risks.

In the UK, the Financial Reporting Council has opened an examination into the adequacy of risk disclosures made the annual reports of two oil and gas exploration companies listed on the London Stock Exchange, Cairn Energy Plc and SOCO International Plc. The investigations, which were prompted by complaints filed by public-interest law firm Client Earth, focus on whether the two companies failed to inform the market about material economic transition risks, and physical risks, relevant to the companies' strategies and business models – in breach of their disclosure obligations under the UK *Companies Act 2006*.

Whilst it may be tempting to dismiss such complaints as predictable activism by environmental interest groups, with little basis in corporate law, this would be both dangerous and inaccurate. Certainly, the merit of the complaints warranted reporting in publications from the Financial Times to The Accountant.

In addition, the Client Earth complaint co-incided with a call to the G20 by 130 large institutional investors, representing US$13*trillion* in assets under management, for greater regulatory scrutiny of climate risk disclosure (see here).

The mainstream credence of such claims is being borne out across the Atlantic, with reports emerging last month that the Securities and Exchange Commission (**SEC**) is investigating whether ExxonMobil's annual reports present a true and fair view of its financial position.

The investigation reportedly focuses on two issues: first, whether ExxonMobil's annual reports accurately convey the extent of the risk to its business from climate change (including regulatory and technological risks) and second, whether balance sheet materially overstates the value of its proven oil reserves, which

MinterEllison

have not been adjusted despite a fall in oil commodity prices of around 60% since 2014[1]. This lies in contrast to the revaluations of other oil and gas majors, who have responded by writing US $50 billion off the stated value of their reserves. ExxonMobil's shares slumped by 1.5% upon the report, wiping more than US$5.3 billion from its market value.

Whilst not driven solely by climate risk-related factors, the reserve revaluation aspect of the SEC's investigation is of particular interest given one of the key economic transition risks associated with climate change: that fossil fuels may be rapidly re-priced as the global economy recalibrates to a low-carbon norm, with booked reserves becoming unrealisable at historical valuations.

This risk has only been compounded with the Paris Agreement coming into force from 4 November 2016, under which 197 countries (including Australia, Brazil, China, Japan, India, Korea, Taiwan, Russia, the US and the major economies within Europe) have agreed to introduce policies to limit global warming to no more than 2°C above pre-industrial average temperatures.

A number of leading institutional reports, from the analysis of Carbon Tracker to that of the Climate Institute and the International Energy Agency, have calculated that the achievement of the < 2°C goal will require a significant proportion of 'proven' fossil fuel reserves currently sitting on corporate balance sheets to remain in the ground, implying marked devaluation (or, in extreme cases, the writing-off) of those assets as Paris commitments are implemented.

The SEC's investigation into ExxonMobil's reserve valuation assumptions provides a stark illustration of the need to ensure that valuation assumptions and methodologies remain current as Paris-driven emissions reductions targets come into force.

It should be emphasised that the developments in the UK and US do not involve the application of any new to disclosure guidelines or regulations. Rather, it illustrates the capacity of general, generic rules around misleading disclosure, and universal corporate obligations to ensure that market disclosures present a true and fair view of both a company's historical performance and its prospects, to apply in a dynamic economic risk environment.

Having said this, specific rules and regulation which mandate specific disclosure on climate change-associated risks are proliferating internationally. As discussed on an earlier Alert in our series (available here), these include:

- the French *Energy & Ecology Transition Law* (Article 173 –VI) (applicable to asset managers, pension funds and insurers from January 2016);

- the voluntary standards suggested by the G20 Financial Stability Board Taskforce on Climate-related Financial Disclosures, chaired by Michael Bloomberg (due for release in December 2016);

- the ASX Corporate Governance Council's 2014 recommendation that companies disclose *material exposure to economic, environmental and social sustainability **risks***; and

- Model Guidance of the global peak-body of stock exchanges, the World Federation of Exchanges (of which the ASX is a member) issued in October 2015. The WFE guidance, entitled *Reporting ESG Information to Investors – A Voluntary Tool for Stock Exchanges to Guide Issuers*, identifies 34 ESG metrics that should be included in reports of listed entities as material drivers of financial performance, including 10 metrics that are directly referable to issues associated with climate change. More than 20 of the Federation's 64 international exchanges have already incorporated the Model Guidance into their exchange rules.

These international regulatory developments do not of course comprise the law in Australia. However, they certainly telegraph the potential direction of our own governance and disclosure laws. These developments are also likely to influence both our regulators and, in the event of litigation in relation to corporate disclosure, the courts.

[1] From a range between $US80 and $115 per barrel during 2011-2014, to a range largely between US$40 and US$60 per barrel since the start of 2015.

Implications for disclosures by Australian firms?

It is clear that the international regulatory environment on climate risk disclosure is moving rapidly around us. This is not to say the relevant issues are unfamiliar to Australian securities laws.

The *Corporations Act* and ASX Listing Rules already require the disclosure of information necessary to present a true and fair view of a corporation's performance and prospects, including material forward-looking risks.

More specifically, in direct parallel to the SEC's investigation of ExxonMobil, in June 2015 the Australian Securities & Investment Commission (**ASIC**) announced that asset valuations and impairments – particularly in the extractives industries - would be a primary focus area for its review of annual reports (see Guidance Note 15-139MR here).

Only this month, ASIC re-issued its guidance on forward-looking statements in the mining and resources industry (such as production targets, forecast financial information and income-based valuations). The guidance gives specific emphasis to the necessity for reasonable grounds for any forecasts, with disclosure of underlying methodologies and assumptions to allow users to assess their reasonableness (see Information Sheet 214, here). The high-profile cases involving the boards of *Centro* and *James Hardie* evidence the preparedness of Australian courts' to hold a corporation's directors liable for misleading statements in their statutory disclosures.

So what does this mean for annual reporting in Australia more broadly?

In short, it is clear that climate change is no longer an issue that can be consigned to a corporate compliance or public relations silo. It's impact on balance sheet items and forward-looking risk and strategy must be reconsidered, in an integrated manner, in the light of contemporary economic realities. This is critical not only for directors, who sign-off on both financial accounts and narrative managerial statements, but accounting and risk advisors.

MinterEllison has been at the forefront of international thought leadership on the implications of climate change for corporate governance, insurance, institutional investment and disclosure. We would be delighted to share other recent Client Alerts on point with you upon request. Please contact ***Sarah Barker*** and ***Maged Girgis*****.**

MinterEllison