More Risks or More Opportunities?

DOMESTIC AND INTERNATIONAL ENERGY TRANSITION IMPLICATIONS ON THE FIDUCIARY RESPONSIBILITIES OF CORPORATE DIRECTORS IN THE PHILIPPINES

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Transcript

International Experience in Identifying and Managing Climate-related Financial Risks and Directors' Duties

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I am here to share what we see globally in the management and disclosure of climate-related financial risks and directors' duties. Why is the energy transition a bordering issue? The answer upfront is that it is a financial and systemic risk issue, so it must be integrated into corporate risk management strategy and disclosure.

There is a growing understanding globally that directors and officers must consider climate issues in their governance role, from oversight of risk management to strategy to signing off on disclosures. Directors and offices may be personally liable through duties and disclosure claims if it is not done well. And what makes potential personal liability for

climate risk issues particularly present in some jurisdictions is the potential for losses of large magnitude like stranded asset risks and strategic climate litigation. And to finish, I will talk about the difference between liability and responsibility.

To start with, directors and office-related liability risks, like any other climate litigation risks to companies, stem from physical and transition risks—the failure to manage or disclose physical and transition risks that could lead to litigation. When we talk about the physical and transition risks, remember that we mean the risks to the profits of the company or institution on the flow and systemic risks, not just the impact of the company on the environment. So, we understand that climate-related financial risks are far-reaching in their breadth and magnitude across the economy on short, medium and long-term horizons. Some sectors, including the financial sector, are particularly vulnerable to these risks.

The KEEP report highlights these transition risks to the energy sector in the Philippines. Bert and Sara talked through many of these transition risks. We got a warning from three Central Bank governors back in 2019 that if some companies and industries fail to adjust to the new world, they will fail to exist. Directors must understand this new risk environment and help their companies navigate the disruption.

Investors and financial regulators are looking at the evidence on the economics of transition. We see an ongoing ratchet of expectations on companies globally despite the COVID-19 pandemic. Regulators and investors are responding to climate science. It does not matter what directors across the globe believe in climate science in the IPCC report last week. Regulators and investors are responding to it. And so through their response to the market trends and the policy requirements, like the policy and pricing signals in the energy transition, and the risks of stranded assets in the fossil fuel and carbon-intensive sectors. These lead to heightened investor expectations, moving from intentions to demonstrable actions to be net-zero by 2050 or sooner.

Through the Network for Greening the Financial System, central banks have called to action on climate risk to integrate stress testing and balance sheets into their supervision. Jamie will discuss central banks more shortly. We see increased supervisory expectations from prudential, corporate, and securities regulators, from the US SEC to the Filipino SEC. Debt markets are accelerating their pricing of climate risks. We have heightened societal expectations of financial institutions on climate change, particularly in Europe. The International Financial Reporting Standards Foundation trustees have guided us on integrating climate risks in financial statements prepared per their accounting standards.

This guidance tells us that climate-related financial disclosures are not just required in the narrative disclosures in the upfront sections of the annual reports like the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations tell us. This accounting standard guidance means that climate and energy issues could be relevant in the numbers in the financial statements. Some companies may need to provide disclosures on how climate and the transition assumptions underlie the accounting estimates.

The Principles for Responsible Investment (PRI), the world's largest body for responsible investment, is telling their investors to control US$ 121 trillion, as the disorderly transition is looking increasingly plausible as the physical impacts increase. The EU continues to push policy and regulatory ambition forward, which has implications across borders. COVID-19 shows the importance of stress-testing and scenario analysis in the face of uncertainty. We have seen disruption to systems and economies that we have not seen outside wartime and that the tail-end risks can happen. These global developments influence the interpretation of legal duties and what we expect of corporate directors.

There is a growing body of legal analysis, mainly published opinions by commercial barristers and commercial law firms, who have never said a green thing in their lives, that climate and ESG factors are a matter of directors' duties. This started in Australia with the famous Hutley opinion that was the first to connect the dots between science, market trends, safe litigation exposures and explain what that means to the directors' duties of care, skill, and diligence.

Then, we have in other jurisdictions, New Zealand, Australia, UK, US, Canada, Singapore, and again back to Australia in 2019 and 2021, when Sydney Council and Hutley gave two other opinions that the standard of care is elevated and that is how quickly this is moving today. In June, the World Economic Forum's Climate Governance Initiative and the CCLI will publish a primer looking at 22 jurisdictions across the globe. Not yet the Philippines, but hopefully the next edition.

It granted that it is not just a legal hurdle as a matter of directors' duties. Still, it is required to take into account climate issues by responsibilities. So, what do directors' duties say about climate issues? Well, the duties to act in the company's best interest require consideration of climate issues to the extent they intersect with the company's interests. And the duty to exercise due care, skill and diligence requires a proactive and increasingly robust consideration of climate risks to fulfil the standard of care.

This is the case even in jurisdictions without expressed stakeholder consideration to take into account the environment or to take into account communities and workers. Why? Because the climate is foreseeable and increasingly material financial risks for companies. So, directors might breach their duties if they fail to consider climate-related financial risks to the company in financial planning, strategy, asset valuation, risk assessment, and disclosure.

In many jurisdictions, on balance, it may be that the reasonable likelihood of the litigation against directors is not high because there are many procedural, evidentiary, and cost-related barriers to claims, particularly in the absence of bad faith. But when we talk to directors globally, regardless of the jurisdiction, we say it will be ill-advised for directors to dismiss the risk of personal liability as remote or theoretical. This is particularly the case for directors of companies in high-risk sectors or those with particular expertise or responsibilities relating to risk management. While insurance provides some financial protection in a claim, its application may not be universal, and it does not mitigate reputational harm for the directors.

Even if the potential liability feels theoretical, there is a difference between meeting the minimum standards and fulfilling a responsibility. Liability is at the very fore. This is where we get the hierarchy of personal exposure. At the top, we have best practices. Then, good governance because is about fulfilling your responsibilities to help your company navigate risks and opportunities. It is also about avoiding reputational issues.

For example, the Exxon Mobil proxy fight, where the directors were replaced a few months ago, avoids litigation. We are already seeing the first litigation against directors. For example, directors of the PG&E in the US were sued after the utility went into bankruptcy because of liabilities for wildfires caused by their poles and wires in drought and heat events made more likely by climate change.

In Australia, we have a case where government officers who heard duties of care and diligence like company directors are being sued for alleged breach of these duties when they signed sovereign bond disclosures that were allegedly misleading on climate risks and down to the bottom said to avoid liability and gross negligence in some jurisdictions. This is a high bar.

To close, the legal and financial imperatives for robust integration of climate and energy issues into risk management, governance, and disclosure are precise. There are risks and opportunities in the energy transition for the Filipino banks. Today's good governance practice requires contemporary understanding, proactive inquiry, and critical evaluation on a forward-looking basis; Understanding what these energy transition trends and drivers mean for your bank to minimise risk and capture opportunities. Net liabilities are in the analysis and advice based on historical norms instead of policy signals.

What used to happen, what used to be the case. That's a red flag. Instead, it is policy signals, modelling, and future scenarios that are key. Globally, we ask directors and officers of financial institutions: How will your governance and oversight help your bank survive and thrive in the disruption of the energy transition?

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