Client Update
Financial Sector Facing Increased Climate-Related Financial and Litigation Risk

Lenders and investors have become attuned to the need to identify and plan for the environmental risks of their investments, especially when those investments are in sectors such as energy or mining. Less developed is the related but distinct area of climate change risk, which is increasingly apparent as a physical, operational, financial, and legal risk to businesses.

In the last week, a coalition of investors including pension funds and asset owners, organized by ShareAction and Boston Common Asset Management, has written to 60 major banks demanding better disclosure on climate risk in the wake of Hurricane Irma. This comes after a landmark claim filed by shareholders against Australia's Commonwealth Bank in August regarding its lack of disclosure regarding climate-related financial risk.[1]

The issue has taken on increased momentum since the adoption in December 2015 of the Paris Agreement, which has had a significant impact at the political and business level. Under the Paris Agreement, 197 countries have agreed to take policy and regulatory actions to reduce their greenhouse gas emissions in publicy available and increasingly ambitious 'Nationally Determined Contributions' ("NDCs"). Even following President Trump's announcement that the United States would withdraw from the Paris Agreement (which cannot legally take effect until November 2020, or the beginning of the next Presidential term), governments and businesses have increased their focus on reducing their climate impacts in line with the Paris Agreement's objectives.[2] Businesses must now expect that their operating environment will be impacted by the implementation of Paris Agreement commitments by the countries in which they operate.

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[1] https://www.theguardian.com/commentisfree/2017/aug/11/new-cba-case-a-warning-step-up-on-climate-change-or-well-see-you-in-court

[2] http://www.debevoise.com/insights/publications/2017/06/united-states-withdraws-from-the-paris-agreement

Against this background, the G20's Financial Stability Board Task Force on Climate Related Financial Disclosures ("TCFD") issued its final recommendations in June 2017. The TCFD recommended increasingly specific public disclosure by listed entities of financial risks related to climate change, with a focus on governance, strategy, risk management, and metrics. One of the key recommendations focuses on the resilience of an organization's strategy, taking into consideration different climate-related scenarios based on varying degrees of temperature rise. Financial regulators appear to be taking note: in June 2017, the Bank of England released analysis on the risk from climate change to financial markets and noted that it was closely following the TCFD's work. The Australian Prudential Regulation Authority warned in February that certain climate risks are distinctly financial in nature, and these risks are foreseeable, material and actionable now.[3] Similar focus can be seen among the securities regulators, for example the U.S. Securities and Exchange Commission and its Canadian counterpart, which announced a climate change disclosure review project in March.[4] A survey conducted by the International Bar Association Securities Law Committee of 25 countries indicates that, unsurprisingly, disclosure of environmental and climate change issues is required in all participating jurisdictions to the extent that they materially affect the value of an issuer's securities.[5] Assessment of such materiality will increasingly come under scrutiny.

Whatever the regulatory environment, banks and other financial institutions increasingly need to account for climate risk, particularly given their mid- to long-term lending portfolios. Publicly-listed borrowers are facing more pressure from investors to disclose climate-related financial risks. For example, the Institutional Investors Group on Climate Change, with 140 members, including many of the largest pension funds and asset managers in Europe, is actively seeking to enhance long-term value by increasing investor awareness of climate risk. In due diligence, lenders should ask about potential physical, regulatory, reputational and financial risks relating to climate change for exposed companies. In their own reporting, lenders should reflect material risks related to climate change and ensure that the disclosure is consistent across financial, sustainability and other reports. Over any lending cycle, lenders should consider climate-related financial risks, in particular any over-inflation of assets or undisclosed liabilities. This includes keeping up to date on investor trends in climate financial risk and divestment from fossil fuels. Building climate risk management into existing risk management practices will help inform strategic decision-making and enhance long-term investment value, as well as help manage the emerging litigation risk in this area.

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[3] http://www.apra.gov.au/Speeches/Pages/Australias-new-horizon.aspx

[4] https://www.securities-administrators.ca/aboutcsa.aspx?id=1567

[5] http://www.debevoise.com/~/media/files/insights/publications/2016/03/20160316_environmental_and_climate_change_disclosure_under_the_security.pdf

Please do not hesitate to contact us with any questions.

NEW YORK

Catherine Amirfar
camirfar@debevoise.com

Gregory J. Lyons
gjlyons@debevoise.com

David W. Rivkin
dwrivkin@debevoise.com

Paul M. Rodel
pmrodel@debevoise.com

LONDON

Wendy J. Miles, QC
wjmiles@debevoise.com

David W. Rivkin
dwrivkin@debevoise.com

Nicola Swan
nswan@debevoise.com