GOVERNANCE

July 2019 Issue 299

The governance issues of business groups

'In order to tip the balance towards better behaviour on the part of controlling shareholders at the group level, there exist a variety of legal and regulatory regimes that attempt to protect external shareholders from potential conflicts with the motivations driving the owners of the wider group as a whole.'

Yin-Hua Yeh

The governance of sustainability

'Dependency on short-term actions: the magnitude and nature of the future impacts will be determined by actions taken today, which thus need to follow a credible and forward-looking policy path. This includes actions by governments, central banks and supervisors, financial market participants, firms and households.'

Richard Smerdon

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The governance of sustainability

Richard Smerdon puts forward a proposal for a new reporting regime and framework to encourage the boards of UK plc to engage with the issue of climate change sooner rather than later.

Introduction

This is the second of two articles in successive editions of *Governance*. The first article argued that the time had now come for the complete dismantling of the UK corporate governance regulatory regime on the grounds that it is very largely ineffective, and that boards spend exorbitant amounts of their time on governance issues. This article argues that the time and resources of a board could be better spent in meeting the sustainability challenge of zero net carbon output by, say, 2030 for FTSE 100 companies and by 2050 for remaining FTSE, AIM and large private companies. Unless successfully challenged, 'climate warming 'will carry a high risk of serious financial instability to financial and industrial Britain. I have called this challenge the 'governance of sustainability'.

This article proposes that UK corporates of any material size should be required to report each year how and what progress is being made to reduce their net carbon output to zero by prescribed dates, on the basis that if they fail so to reduce they run the risk of becoming themselves unsustainable and therefore should become the subject of disinvestment and refusal to invest/lend. The programme would be supervised by the UK's central bank, the Bank of England.

Key players

NGFS: Network for Greening the Financial System. Set up in 2017 by the Bank of England, Banque de France and the People's Bank of China it now has 36 central banks and regulators, two thirds of the global systemically important banks and insurers. The US and Brazil are the only two notable absentees.

FSB: The Financial Stability Board is an international body that monitors and makes recommendations about the global financial system. It was established after the G20 London Summit in April 2009 as a successor to the Financial Stability Forum.

TCFD: The FSB established the Task Force on Climate-Related Financial Disclosures led by businesses from a wide range of industries across the G20. Eighteen months later, the TCFD delivered to the Hamburg G20 Leaders Summit its recommendations for voluntary disclosures of material climate-related financial risks.

The background to the proposal

In September 2015 Mark Carney, Governor of the Bank of England, delivered a speech[1] at Lloyds of London in which he said, amongst many significant things, that climate change has become a financial stability risk:

'We don't need an army of actuaries to tell us that the catastrophic impacts of climate change will be felt beyond the traditional horizons of most actors – imposing a cost on future generations that the current generation has no direct incentive to fix…

'…The horizon for monetary policy extends out to two to three years. For financial stability it is a bit longer, but typically only to the outer boundaries of the credit cycle – about a decade. In other words, once climate change becomes a defining issue for financial stability, it may already be too late. This paradox is deeper, as Lord Stern and others have amply demonstrated. As risks are a function of cumulative emissions, earlier action will mean less costly adjustment. The desirability of restricting climate change to two degrees above pre-industrial levels leads to the notion of a carbon "budget", an assessment of the amount of emissions the world can "afford".'

In 2017 the Bank of England, with other central banks formed the NGFS and in April 2019 the NGFS issued a Report[2] in which it said:

'Climate change is one of many sources of structural change affecting the financial system. However, it has distinctive characteristics that mean it needs to be considered and managed differently'. The Report went on to describe some of the effects of climate change.

These include:

- Far-reaching impact in breadth and magnitude: climate change will affect all agents in the economy (households, businesses, governments), across all sectors and geographies;
- Foreseeable nature: while the exact outcomes, time horizon and future pathway are uncertain, there is a high degree of certainty that some combination of physical and transition risks will materialise in the future;
- Irreversibility: the impact of climate change is determined by the concentration of greenhouse gas (GHG) emissions in the atmosphere and there is currently no mature technology to reverse the process;
- Dependency on short-term actions: the magnitude and nature of the future impacts will be determined by actions taken today, which thus need to follow a credible and forward-looking policy path. This includes actions by

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governments, central banks and supervisors, financial market participants, firms and households.

The NGFS, as a voluntary, consensus-based forum then made six recommendations for central banks, supervisors, policymakers and financial institutions to enhance their role in the greening of the financial system and the managing of environment and climate-related risks.

The recommendations are not binding and reflect the best practices identified by NGFS members to facilitate the role of the financial sector in achieving the objectives of the Paris Agreement.

In June 2017 the TCFD issued its 'Final Report on Climate Related disclosures' and followed that up with recommendations as to how companies could voluntarily monitor and report the disclosures[3].

The TCFD structured its recommendations around four thematic areas that represent core elements of how organisations operate: governance, strategy, risk management, and metrics and targets. These thematic areas are designed to interlink and inform one another.

Thus, to summarise: the speeches and reports referred to above show that the risks of *serious financial instability* arising from the unsustainable use of the world's resources are now understood by the world's major central banks (save, apparently, the US). They in turn are exerting pressure through the NGFS, the FSB and the TCFD to require that *individual states* should now begin to organise *their* financial regimes so as to require corporations operating within these states to take action to meet the challenge and to disclose what they are doing to meet the challenge. In the next paragraph the author discusses how this might be done within the UK.

A proposal for action by UK corporates

Companies, beginning with the FTSE 100 and extended over a period of, say, five years through the FTSE 350 to large private companies coming within the scope of the Wates principles, would be required to set out in their annual reports how they intend to reduce their net carbon output to zero. FTSE 100 companies would have to report in respect of a deadline of 2030 and companies outside the FTSE 100 including large private companies would operate on a taper to a deadline of 2040 and 2050.

At the same time policy-makers and institutional investors would also encourage a cohort of self-selected trailblazers to 'beat' the 2030 target and share their know-how and experience publicly.

Companies would be required to report each year how they are progressing against metrics still being designed but which would be internationally recognised. Institutional investors would be held to account by the Bank of England in enforcing the 'governance of sustainability' by their investee companies. In other words the process will be driven by institutional investors and monitored by the UK's central bank, ie the Bank of England. The sanctions against companies for failure ultimately would comprise disinvestment and refusal to invest/lend[4].

Governance

The TCFD in its guide issued on 14 January 2019[5] offered guidance on the governance structures for corporates which would assist in the meeting of its 2017 Recommendations. The author has modified this guidance so as to match up with the proposal in this paper for zero net carbon output by corporations by 2030 onwards.

Board oversight

- Training of board members on climate change, financial and other risks arising, the current level if any of the sustainability of the corporation's business and the action required to achieve the zero net carbon output by 2030/40/50.
- Agreement at board level of the metrics to evidence and validate the action required.
- Clear description of who has ultimate accountability for management, measurement and public reporting of the zero net carbon programme.
- Clear description of roles and responsibilities of the board committee and executive team charged with measuring, reporting and achieving the zero net carbon output programme.
- Climate-specific structures/committees in place (if any) and related decision-making processes.
- Methodology for and amount of incentives to promote management of climate-related risks at board level (but see below under 'executive incentives').

Metrics

It is, of course, of vital importance that the metrics used to measure the net carbon output of corporates should be robust, universally accepted and capable of independent verification. Cheating must be exposed. The work of the TCFD so far in the field of metrics is impressive, and the author has no doubt that it will be possible to devise a system of measurement and verification which will take the strain.

Executive incentives

Whilst the author can see no alternative option to incentivising executives to achieve the zero target other than by various forms of pay, boards must not allow pay consultants to lead

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them by the nose into paying executives exorbitant rewards for what is after all no more than 'doing their job', namely, ensuring that the company has a sustainable future.

Conclusion

It is hoped that this article has shown that much good work is being done both at international and at national levels in defining and appreciating the financial risks of climate change. Translating that work into actual performance by individual corporations is the next challenge. It's a huge challenge, but on the way to meeting it businesses may well find new and more profitable ways of doing things.

Richard Smerdon. Author, 'A Practical Guide to corporate governance', 1st to 4th editions, Sweet & Maxwell. Former tutor to the Financial Times Non-Executive Directors Diploma. Former corporate finance partner, Osborne Clarke. The writer is writing in a personal capacity and none of the views expressed are to be attributed to any of the organisations above mentioned.

1 Mark Carney: Breaking the tragedy of the horizon – climate change and financial stability Speech by Mr Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at Lloyd's of London, London, 29 September 2015.

2 Network for Greening the Financial System: First comprehensive report: A call for action: Climate change as a source of financial risk, April 2019.

3 Network for Greening the Financial System: First comprehensive report: A call for action: Climate change as a source of financial risk, April 2019.

4 In an interview with the *Guardian* paper reported on 11 May 2019 Mr John McDonnell, Shadow Chancellor of the Exchequer, stated that a future Labour Government would de-list companies from the LSE unless 'they do more to tackle climate change'.

5 'How to implement the TCFD recommendations: a step-by-step guide', 14 January 2019, David Wei and Giulio Berruti.

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