Intelligence MEMOS

From: Janis Sarra

To: Canada's Boards of Directors

Date: March 4, 2021

Re: **DIRECTORS NEED HELP ON CLIMATE CHANGE**

Canada's post-pandemic economic recovery will take shape alongside its commitment to achieve net-zero carbon emissions by 2050.

Although COVID-19 is an unexpected catastrophe, climate change is an expected one, which makes the political risks related to climate policy – and the risks that directors will be taken to task for not anticipating the consequences of climate change on their companies, or that their companies will themselves be seen as risky investments for not anticipating them – particularly salient.

In my new C.D. Howe Institute E-Brief, I examine how boards can better gauge and offset these risks by focusing on the legal duties of corporate directors to act in the best interests of their company as they develop strategies to address climate-related financial risks to their business.

Canada should clarify and adopt mandatory uniform reporting on climate metrics and finance, so that corporate officers can offer investors information that is transparent, comparable year over year and comparable between companies in a sector.

Climate change presents a unique challenge for Canadian businesses due to the interconnected nature of the risk: the Sustainability Accounting Standards Board reports that climate change materially affects 72 of 77 industry subsectors.

The risk to businesses can be broken down into two components: physical risks and transition risks. "Physical risks" include acute events such as disruption to business activity from wildfires, hurricanes, extreme rainfall and flooding attributable to climate change, all of which are already damaging business assets and disrupting manufacturing operations and supply chains in Canada.

The International Financial Reporting Standards (IFRS) notes that potential financial implications include asset impairment, and changes in the fair valuation of assets, in contingent liabilities, and in expected credit losses for loans and other financial assets.

"Transition risks" from climate change include market risks due to changing consumer and investor preferences; policy risks as governments implement carbon pricing and other decarbonization requirements; technological risks as companies adopt low-carbon processes or innovations or languish for failure to adopt them; and reputational risk in respect of investors, consumers and civil society.

Transition risks also include "litigation risk" – the costs to companies from lawsuits for damages paid for breach of fiduciary obligation, failure to disclose material financial risks to investors or tort claims as a result of losses due to acute events. Although civil litigation against corporations has not yet commenced in Canada, 1,600 climate cases are pending globally, some from climate activists against governments, but many initiated by state and municipal governments seeking damages from high-carbon-emitting companies for the costs to repair infrastructure from climate impacts.

The absence of lawsuits against companies in Canada could change as climate cases in other countries find directors liable for failure to act on climate risks or regulators begin to enforce failure to disclose material climate-related risks under Canadian securities law.

Directors therefore need to consider the risks – now well documented by both the scientific and investment communities – determine what are material to the business, and have a strategy to minimize such risks and capture any opportunities presented by new technologies and energy-saving innovations.

Directors need to understand that meeting their duties of care and loyalty requires climate risk to be on the board agenda, tailoring their decisions to the sector and circumstances in which the company operates.

Despite the legal clarity in place, more could be done to help directors along the way. Finance has a key role in this regard. A number of international efforts are underway to establish a "taxonomy" – a tool defining the effect of financial products on carbon emissions. Consistent definitions would help companies, boards, investors, underwriters and issuers navigate the transition to a low-carbon economy. A taxonomy would give investors the ability to assess whether companies are using capital to address climate-related risks and opportunities, and, by extension, would allow boards to report in a consistent manner on how their activities are reducing these risks.

Canada's largest banks, insurance companies and pension funds are currently funding development of a made-in-Canada transition-finance taxonomy that recognizes our heavy dependence on natural resources and other high-carbon-emitting sectors.

The duties of directors and corporate officers already require diligent consideration of climate change risks and opportunities, but more clarity is needed, especially around the transformative potential of their operations. Governments could also provide more clarity through legislative reforms or regulatory guidance on best practice.

Failure of directors to address the implications of climate change, however, is not an option.

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