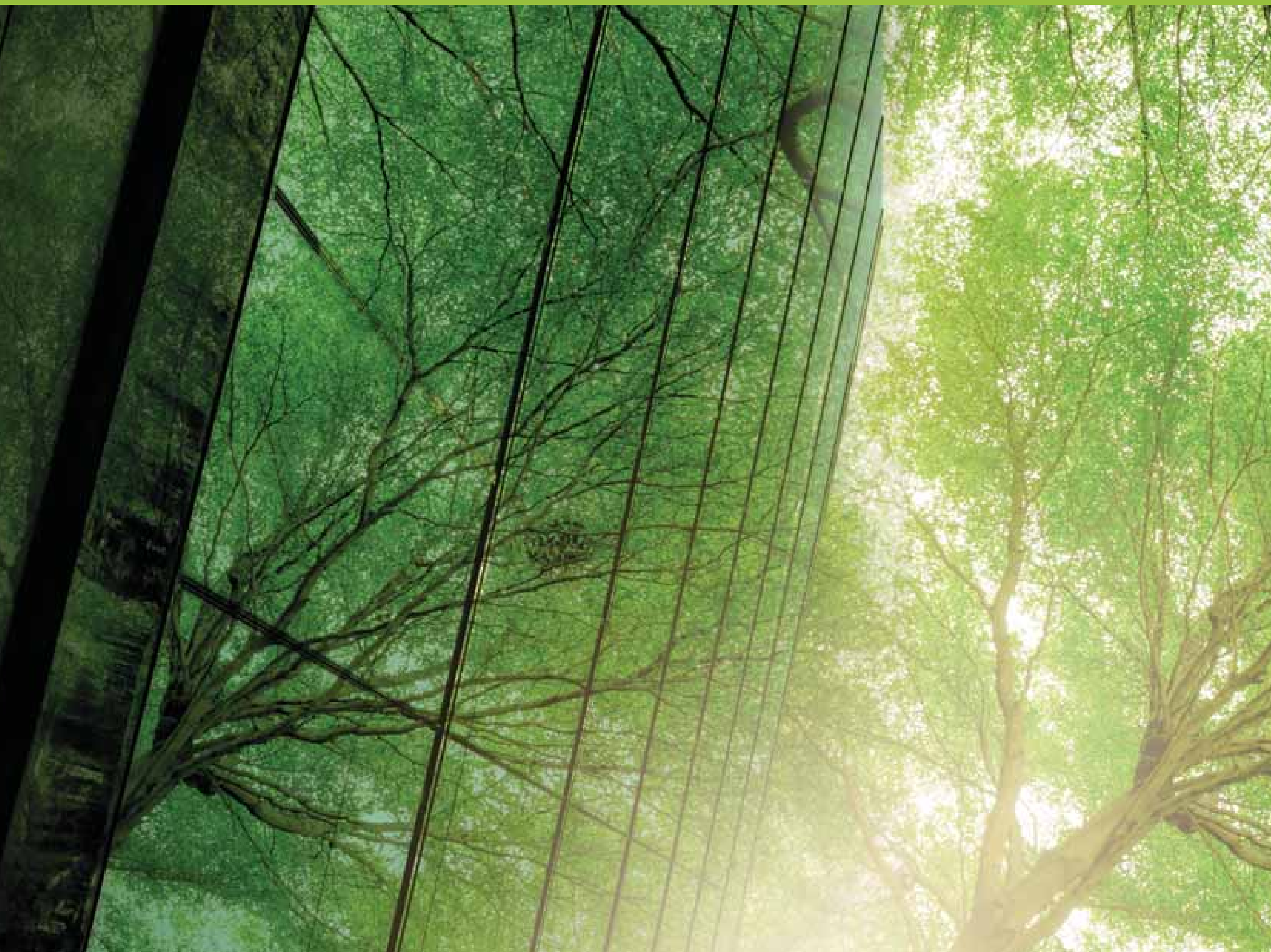
ADVANCING CORPORATE CLIMATE GOVERNANCE TO MEET THE PARIS AGREEMENT OBJECTIVES



> “The heightened focus on climate and sustainability-related disclosures has set in motion an urgent process of internal transformation in entities. Strong corporate climate governance is at the heart of this transformation.”

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This article explores how corporate climate governance is critical to achieve the transition to a low-carbon and climate-resilient economy and highlights the pressing need for companies and financial institutions to take climate action. It also discusses the EBRD's technical cooperation projects, focusing specifically on the Bank's support for the development and implementation of corporate climate governance action plans.

CLIMATE ACTION: THE NEED OF THE HOUR

The Paris Agreement sets the objective of limiting average global temperature rise to between 1.5°C and well below 2°C above pre-industrial levels.[1] To achieve greenhouse gas (GHG) emission reduction in line with this temperature increase goal, states have formulated forward-looking plans with clear climate commitments referred to as nationally determined contributions (NDCs).[2] The Paris Agreement explicitly references the private sector's role in implementing NDCs and the Intergovernmental Panel on Climate Change (IPCC) also recognises that partnerships involving non-state public and private actors, among others, would facilitate actions and responses consistent with the temperature increase goal of the Paris Agreement.[3, 4]

In the latest IPCC report, however, a lack of private sector engagement and insufficient private sector sources of climate finance have been identified as key barriers, with public and private finance flows for fossil fuel projects being greater than those for climate mitigation and adaptation.[5] As such, an

urgent systemic transformation is needed, and it is vital that private and public sector entities identify and establish climate-related targets for their assets, portfolios and supply chains. With growing consensus that climate and sustainability-related data are essential to monitor progress towards achieving the Paris Agreement goals, mandatory regulatory requirements and voluntary market-driven standards have emerged that set requirements for entities to identify, assess, manage and report on sustainability and climate-related matters.

The recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD) are a pioneering market-driven initiative in this regard. These recommendations span four thematic areas that are central to the functioning of public and private enterprises: governance, strategy, risk management, and metrics and targets. The TCFD provides guidance on what information entities should disclose to support investors, lenders and insurance underwriters in assessing and pricing climate-related risks.[6] The aim is to encourage

1. United Nations Framework Convention on Climate Change, Article 2(1a). Available at: https://unfccc.int/sites/default/files/english_paris_agreement.pdf, (last accessed on 19 September 2023).
2. United Nations Framework Convention on Climate Change, Article 4. Available at: https://unfccc.int/sites/default/files/english_paris_agreement.pdf, (last accessed on 19 September 2023).
3. United Nations Framework Convention on Climate Change, Article 6(8b). Available at:https://unfccc.int/sites/default/files/english_paris_agreement.pdf, (last accessed on 19 September 2023).
4. IPCC (6 October 2018), *Special Report: Global Warming of 1.5°C, Summary for Policymakers*, At D.7.1. Available at: https://www.ipcc.ch/sr15/chapter/spm/, (last accessed on 19 September 2023).
5. IPCC (March 2023A), *AR6 Synthesis Report: Climate Change 2023, Summary for Policymakers*, Sixth Assessment Report. Available at: https://www.ipcc.ch/report/ar6/syr/downloads/report/IPCC_AR6_SYR_SPM.pdf, (last accessed on 19 September 2023).
6. TCFD, https://www.fsb-tcfd.org/recommendations/, (last accessed on 19 September 2023).

entities to identify the financial risks and opportunities related to climate change as part of their risk management and strategic planning processes.

In a more recent market-driven endeavour, sustainability standards have been published by the International Sustainability Standards Board (ISSB). These standards build on the recommendations of the TCFD, but require more specificity for climate-related disclosures. The ISSB seeks to set a high-quality, comprehensive global baseline of sustainability disclosures focused on the needs of investors and the financial markets. While both the ISSB standards and TCFD recommendations are voluntary, jurisdictions such as the United Kingdom,[7] Singapore,[8] Nigeria,[9] Australia and others have already expressed strong support for reporting in line with them.[10] In addition to voluntary initiatives, stricter national and regional regulations are coming into force across jurisdictions such as the European Union (EU), Egypt, Georgia and the United States.

The heightened focus on climate and sustainability-related disclosures has set in motion an urgent process of internal transformation in entities. Strong corporate climate governance (CCG) is at the heart of this transformation as, to make accurate and reliable climate and sustainability-related disclosures, entities would need to (1) establish the appropriate internal governance and operational arrangements; (2) establish relevant policies, processes and management practice guides; and (3) develop strong internal capacity.

THE EBRD'S CORPORATE CLIMATE GOVERNANCE FACILITY: SUPPORTING CLIENTS AND RAISING AWARENESS

CCG is the set of rules, practices and processes that an entity puts in place to identify, manage and improve decision-making and disclosures related to the impacts of climate change. The EBRD is the first international financial institution to set up a CCG facility that brings together lawyers, economists and policy experts to help private sector and state-owned enterprises (SOEs) develop and strengthen their climate-related governance, strategy, risk management, target setting and disclosure practices. In particular, the EBRD provides dedicated support to clients to develop and implement corporate climate governance action plans (CCGAPs). These plans involve the two key components discussed below.

A. Assessment: Identifying corporate governance gaps with respect to climate

The first step is to understand the entity's corporate governance practices and to assess their suitability for identifying and addressing climate-related risks and opportunities. International standards and, where applicable, regional and national regulations form the benchmark for this analysis. This assessment looks at the entity's practices in the context of the TCFD's four thematic areas in order to identify material sustainability and climate related risks and opportunities. It is interesting to see that prevailing regulations and standards have different expectations regarding the assessment of the "materiality" of identified climate-related risks and opportunities.

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7 Financial Conduct Authority, Policy Statement 21/23, *Enhancing climate-related disclosures by standard listed companies*. Available at: https://www.fca.org.uk/publication/policy/ps21-23.pdf, (last accessed on 19 September 2023).

8 Accounting and Corporate Regulatory Authority, *Public Consultation on Turning Climate Ambition into Action in Singapore - Recommendations by the Sustainability Reporting Advisory Committee*. Available at: https://rb.gy/f4qdg, (last accessed on 19 September 2023).

9 Nigerian Stock Exchange, *Strengthening the Competitiveness of African Economies*. Available at: https://ngxgroup.com/ngx-regulation-urges-public-private-sector-to-implement-initiatives-against-climate-change/; and Financial Reporting Council of Nigeria, *FRC, ISSB & NGX Regulation Limited Launch IFRS S1 & S2 Sustainability Disclosure Standards in Nigeria*. Available at: https://rb.gy/nm0i8, (last accessed on 19 September 2023).

10 Environmental Finance (18 July 2023), "Australia to align standards with ISSB". Available at: https://rb.gy/9fxdj, (last accessed on 19 September 2023).

For example, the ISSB standards focus on "financial materiality" by applying only to sustainability and climate-related risks and opportunities that affect an entity's cash flows, its access to finance or cost of capital. This is because the ISSB standards focus on the needs of investors and providers of capital. On the other hand, the European Sustainability Reporting Standards require disclosure of information which is material both in terms of the impact on an entity's financial value and the entity's impact on people and the environment – "impact materiality" or "double materiality" – thereby focusing on a broader set of stakeholders than merely investors.[11]

In any event, entities must consider both physical climate risks (the impacts on physical assets arising from the occurrence of extreme weather events and gradual shifts in climate patterns) and transition climate risks (the financial risks, such as the risk of stranded assets, which result from the process of adjustment towards a low-carbon economy). The assessment process would include scoping of portfolios and value chains (both upstream and downstream) as well as infrastructure and physical assets to identify potential climate sensitivities. This would cover both sensitivity to transition risks (for example, reliance on carbon-intensive inputs or exposure to climate litigation) and to physical risks (such as water-intensive activities or exposure of key facilities to extreme weather events).

From a strategic and risk management perspective, the damage to or destruction of a company's physical assets can reduce its productivity and output as well as adversely impact its financial position. Financial institutions having contractual ties with such affected companies may also suffer financially owing, for instance, to the affected company's inability to service debt repayments, diminished equity returns and/or a depreciation in collateral value. On the other hand, financial losses from transition risks can arise in several ways for both companies and financial institutions. These include climate-related mitigation policies (such as the introduction of a "green" tax), shifts in public sentiment (such as increased climate-related litigation) and evolving regulatory/supervisory expectations (such as the introduction of more stringent climate-related reporting requirements).

11 The ESRS are drafted by the European Financial Reporting Advisory Group pursuant to the EU Corporate Sustainability Reporting Directive. The ESRS were adopted on 31 July 2023.

The EBRD has developed a corporate climate governance matrix and associated questionnaire to assist with the assessment of a client's maturity level across three stages with respect to corporate climate governance practices.

B. Capacity building: Improving CCG and disclosure practices

The EBRD has developed a CCG matrix and associated questionnaire to assist with the assessment of a client's maturity level across three stages – early stage, developing stage and advanced stage – with respect to CCG practices. The matrix and questionnaire are based on existing and emerging voluntary standards and regulations, and are designed to help companies identify their current maturity level as well as graduate from one maturity level to the next. Once an entity's CCG maturity is identified, the Bank's next step is to help formulate a CCGAP commensurate with the maturity level of the entity's current corporate (climate) governance practices.

- **Governance**: The allocation of responsibilities and accountability mechanisms of the board, operational committees and senior management in identifying, managing and monitoring climate-related matters must be clearly established and disclosed. To govern climate risks and opportunities effectively, organisational procedures for communicating identified risks to the board and relevant committees for due consideration should be clearly defined. To develop the competence of the board and executive officers, steps should be taken to improve their knowledge of and resources for climate risks and opportunities. In terms of more advanced practice, executive incentives could be linked to climate-related targets and indicators, where appropriate.

Supporting climate governance for a Tunisian energy utility

Tunisia's mitigation efforts under its NDC focus on the energy sector, as it is one of the biggest contributors to GHG emissions in the country. Tunisia's state-owned utility – Société Tunisienne de l'Electricité et du Gaz (STEG) – is the central player in the domestic energy sector as it is solely responsible for distribution and transmission of electricity and gas, acts as the single buyer for all generation output and controls electricity generation. As such, STEG's long-term sustainability is critical for the green energy transition in Tunisia.

Since December 2020, the EBRD has been providing technical cooperation to STEG to implement a detailed reform and energy sustainability roadmap to improve its CCG. Under the CCGAP developed with STEG, clear reporting and accountability structures across its operational departments were established and, notably, the responsibility for approving climate-related risk and strategy (including key climate-related performance indicators) was allocated to the board. This is a major step forward for STEG and is an example for other SOEs in the region, especially considering the challenges that such enterprises face in making governance changes. As an outcome of the CCGAP project, STEG adopted a new corporate climate strategy in 2022, which provides a clear strategic roadmap for reaching the objectives of Tunisia's NDC targets.

- **Strategy:** As climate-related impacts are becoming clearer to entities, organisational procedures must be reinvented to ensure the identified climate-related impacts systemically inform investment planning and decision-making processes. As part of this, disclosures should include transition plans. A transition plan is a time-bound action plan that clearly outlines how the entity will pivot its assets, operations and business model to align with the goals set by the Paris Agreement.[12] Transition plans are encouraged so the entity has the benefit of a blueprint to tackle climate issues. This would also enable investors and other stakeholders to assess the entity's commitment to achieving a low-carbon and climate-resilient pathway.

Supporting transition planning for financial institutions

In December 2022 the EBRD published its Paris Agreement alignment methodology, which sets out the Bank's commitment to screen all its lending operations to ensure they are on track to limit global warming to no more than 1.5°C.[13] In particular, as part of this effort in the context of the EBRD's indirect lending operations (that is, EBRD finance extended to financial institutions which on-lend the funds to local projects or investments), the Bank provides technical cooperation to such financial institutions to prepare and implement their own transition plans. The aim is for these financial institutions to ensure their entire portfolio aligns with the goals of the Paris Agreement, well beyond the EBRD's own financial support, thereby bringing about a systemic change. Bank al Etihad, the fourth-largest bank in Jordan in institution to sign up to develop a pilot institutional transition plan with EBRD support to align its business practices and financial flows with the goals of the Paris Agreement.[14]

12 CDP, https://www.cdp.net/en/guidance/guidance-for-companies/climate-transition-plans, (last accessed on 19 September 2023).

13 Methodology to determine the Paris Agreement alignment of EBRD investments (December 2022). Available at: https://www.ebrd.com/ebrd-activities-paris-alignment, (last accessed on 19 September 2023).

14 EBRD press release, "EBRD and Bank al Etihad support growth of small and women-led businesses in Jordan" (December 2022). Available at: https://www.ebrd.com/news/2022/ebrd-and-bank-al-etihad-support-growth-of-small-and-womenled-businesses-in-jordan.html, (last accessed on 19 September 2023).

- **Risk management:** Entities must carry out a materiality assessment to define how the identified climate-related risks and opportunities affect their business, strategy and financial planning. It should also be clearly established which business divisions or units are responsible for identifying, disclosing and managing material climate-related risks and their reporting lines to senior management. The principle of double materiality requires that businesses consider not just the financial impact of climate-related risks and opportunities on the entity, but also the entity's impact on people and the environment.

Strengthening the climate resilience of supply chains in Türkiye

Olam International is a leading food and agribusiness company supplying food, ingredients, feed and fibre in more than 60 countries worldwide. Olam Food Ingredients (ofi), a member of the Olam Group, operates in several supply chains – hazelnuts, coffee, palm oil, cocoa and others – where material social and environmental challenges exist. With the EBRD's assistance, ofi has undertaken a climate-related risk scenario analysis to thoroughly understand the risks and opportunities associated with low-carbon transition and physical climate impacts in ofi's hazelnuts operations in Türkiye. To put this in context, it is estimated that 70 per cent of the world's hazelnut supply is sourced from Türkiye.[15] The scenario analysis exercise with ofi led to the formulation of recommendations on how climate actions can be implemented within value chains to improve climate adaptation and resilience for Turkish hazelnut farms that form part of ofi's supply.[16]

15 ofi, *Sustainability in hazelnuts*. Available at: https://www.ofi.com/sustainability/responsible-and-sustainable-sourcing/sustainability-in-hazelnuts.html, (last accessed on 19 September 2023).

16 *Olam Group Limited Annual Report 2022*. Available at: https://www.olamgroup.com/content/dam/olamgroup/investor-relations/ir-library/annual-reports/annual-reports-pdfs/2022/olam_annual_report_2022.pdf, (last accessed on 19 September 2023).

17 *National Climate Change Adaptation Strategy and Action Plan* (2019), Annex 3 (Energy sector). Available at: https://rb.gy/630ne6, (last accessed on 19 September 2023).

Supporting target-setting for a Bulgarian utility

Since 2022, the EBRD has been helping a Bulgarian electricity distribution company develop and implement a CCGAP. Climate change vulnerability and risk analysis for Bulgaria shows that the energy sector (including critical infrastructure) will be among the most affected sectors in the country.[17] Electricity utilities are particularly susceptible to the physical risks of climate change, such as the exposure of network infrastructure to extreme weather events, as well as transition risks, including the evolving regulatory landscape relating to climate change and green energy in the EU. As part of the CCGAP, the distribution company was encouraged to consolidate, among other indicators, information on GHG emissions, energy consumption, renewable energy capacity and climate-related incidents affecting operations. It was suggested to monitor the evolution of each indicator and to set targets over the short (<2 years), medium (<5 years) and long term (>5 years).

- **Metrics and targets:** Entities must disclose the key metrics used to assess climate-related risks and opportunities in line with their risk management and transition planning ambitions. Ideally, climate-related targets should be formulated across multiple time scales (short, medium and long term) and include interim targets. Disclosures should also involve a description of the methodologies used to calculate metrics and targets. As an entity's disclosure practices become more sophisticated, the metrics must be comprehensive and granular enough to cover different regions, businesses and/or products.

IMPLEMENTATION CHALLENGES

The process of implementing CCGAPs is not without challenges, such as:

- **Availability of data:** CCG enables entities to use climate-related information in internal processes and decision-making, thereby promoting systemic changes that help to develop low-carbon and climate-resilient pathways for business operations. However, to accurately identify and evaluate climate-related risks and opportunities and undertake climate-related stress testing and materiality assessments, the available information must be high-quality, reliable and comparable. Further improvements in the quantity, quality, reliability and comparability of disclosures are urgently required. In 2020 the EBRD launched a policy initiative to help stock exchanges in our regions develop sustainability reporting guidelines based on applicable national and regional frameworks, with the aim of improving the quality of data reported by companies and helping market participants align with best practice standards for disclosure and reporting. Under this initiative, the Bank has provided support to the Prague Stock Exchange (2023), the Bucharest Stock Exchange (2022), the North Macedonia Stock Exchange (2022) and the Warsaw Stock Exchange (2021) in their development of sustainability-reporting guidelines.

- **Lack of standardisation and alignment:** There is considerable variation across entities and sectors with regard to the content, methodology of preparation and form of presenting climate-related information in disclosures, as well as transition plans. There is also a lack of transparency with regard to the methodologies and approaches applied. The fragmentation of climate reporting has resulted from the multitude of third-party reporting frameworks and gaps in interoperability. Transition planning is still a nascent activity and what these plans should include – and how individual low carbon pathways fit within sector or country pathways – is not always clear. However, the efforts of the ISSB and the European Commission towards ensuring interoperability and developing guidance may address this issue.
- **Lack of capacity and awareness:** Boards and operational teams must be equipped with the right tools and skills to fulfil their obligations with respect to climate-related governance, strategy and reporting. This requires ongoing training and capacity-building support. The nature of support will need to be tailored to the relevant sector, market, country-specific regulatory framework and maturity level of the entity. The EBRD has been successfully working with the Climate Governance Initiative (CGI) since 2022 to provide such support in its regions.[18] For example, the CGI and the EBRD jointly launched Chapter Zero for Ukraine and the Caucasus in 2022 to accelerate knowledge delivery, peer-to-peer learning and sharing of best practices among boards and senior management in these regions.[19]
- **Businesses are oriented to focus on short-term results and value creation:** Businesses are traditionally oriented to deliver short-term value and returns for stakeholders. This can tend to be at odds with the long-term objective setting and risk management required for climate-related matters. As the board's positioning of the entity on short-term decisions can have important long-term implications for organisational resilience to climate change, it is critical to consider how climate change might alter the future business landscape.

CONCLUSION

Private sector and public sector enterprises have a critical role to play in the transition to a low-carbon and climate-resilient economy. Strategic and risk management decisions and action will either slow or accelerate the pace of climate change and how we adapt to it, which will in turn shape risks and opportunities for businesses. Failing to reorient the business environment to address climate change or inability to clearly demonstrate positive action could have a major impact on the sustainability, financial performance, reputation and risk profile of entities.

The EBRD has a vital role to play in helping its clients address climate-related risks and identify business opportunities with reference to the relevant international standards and mandatory regulatory requirements. The Bank is also uniquely placed to offer such support given its focus on, and close relationship with, the private sector and public sector enterprises in its regions. By providing such assistance, the EBRD can enable its clients to identify the most effective pathways towards alignment with the Paris Agreement goals.

18 EBRD press release, "CGI partner up to promote corporate climate governance" (April 2022). Available at: https://www.ebrd.com/news/2022/ebrd-cgi-partner-up-to-promote-corporate-climate-governance.html, (last accessed on 19 September 2023).

19 EBRD press release, "Climate governance platform launched for business leaders in Ukraine, Georgia and Armenia" (September 2022). Available at: https://www.ebrd.com/news/2022/climate-governance-platform-launched-for-business-leaders-in-ukraine-georgia-and-armenia.html, (last accessed on 13 September 2023).