DEEP DIVE

From green to gold: 5 ways CFOs can gain from climate risk disclosure

CFOs confronting growing pressure to disclose climate change risks can find in their analysis opportunities to improve capital allocation and risk management.

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Reporter

CFOs face rising heat to combat climate change from a range of stakeholders.

Activists demand commitments to shrink carbon footprints. Investors want both green operations and robust profits. Regulators — including the Securities and Exchange Commission (SEC) — are gearing up to require detailed disclosures on climate risks.

When handling such pressure, financial executives draw from an ill-fitting set of tools. They lack a single, detailed framework for measuring climate risk that is recognized across industries, markets and jurisdictions worldwide.

Instead, CFOs must choose from among several systems that use different calculation methods and data definitions. The result — they often get just a loose grip on climate risk, according to accountants and experts in sustainability measurement.

"Lack of standards, and differences among standards, can create barriers to climate risk management," according to a Commodity Futures Trading Commission (CFTC) panel. "It is extremely difficult for individual institutions to secure all the data necessary for detailed datasets."

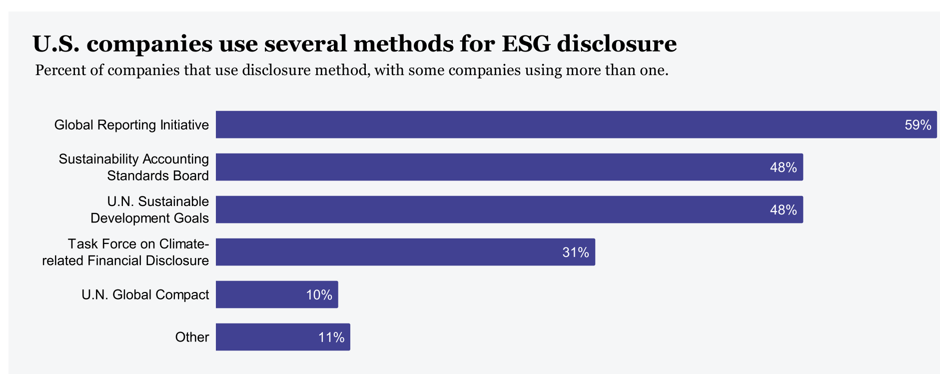
CFOs can still yield useful insights on the impact of climate change by following strategies that range from scenario planning and identifying their company's worst vulnerabilities, to relying on the highest-integrity data and separating estimates from facts.

The insights can reveal ways for CFOs to curb risk, eliminate waste and cut the cost of capital through "green financing," according to accountants and experts in sustainability measurement.

With a clearer view of a company's environmental, social and governance (ESG) performance, a CFO can also improve capital allocation by identifying merger and acquisition opportunities or business lines that are difficult to switch to low-carbon operations and ripe for divestiture.

"More and more people are seeing opportunities with respect to ESG — creating new products, developing new materials, finding new ways to get a product to market," according to Robert Hirth, co-vice chair of the Sustainability Accounting Standards Board (SASB).

"There's absolutely an increased demand for this reporting," Hirth said, predicting that lenders and insurers at some point will routinely ask financial executives for ESG performance data.



JimTyson/CFO Dive, data from IFAC

CFOs can find big vulnerabilities when gauging climate change impact, the accountants and experts in sustainability measurement said.

For example, Fannie Mae and Freddie Mac, government-sponsored enterprises, guaranteed $6.88 trillion in mortgage debt in 2019 without pricing flood risk into their guarantee fees.

Also, the value of assets at fossil fuel companies worldwide might fall from between $250 billion and $1.2 trillion during the transition to alternative energy, the CFTC's climate-related market risk sub-committee said in a September report.

At the same time, CFOs who identify and curtail climate risks — or who help speed the transition to clean energy — can reduce their companies' cost of capital.

In a high-profile example of the payoff from sustainable business, Tesla's share price has surged more than sevenfold since the start of 2020. Lesser known companies focused on battery technology and solar or wind power have scored spectacular gains as well.

In the less glamorous market for municipal bonds, most counties pay less in underwriting fees and bond yields than their counterparts that are vulnerable to climate change.

Meanwhile, lending for sustainable business is growing. JP Morgan Chase and Bank of America have recently committed $2.5 trillion and $1.5 trillion, respectively, toward low-carbon business and sustainability during the coming decade.

CFOs slow to “go green” may soon get a nudge from U.S. regulators. SEC Chair Gary Gensler aims to require companies to disclose their response to climate change risks, including details on metrics such as greenhouse gas emissions.

Treasury Secretary Janet Yellen in April backed the SEC’s push for disclosure and said the Treasury will consider ways to promote the Biden administration's greenhouse gas reduction goals through taxation, international cooperation and economic policy.

Also, the Federal Reserve in January announced the creation of a supervision climate committee to “develop an appropriate program to ensure the resilience of supervised firms to climate-related financial risks.”

High hurdles

CFOs face several challenges as they follow regulatory pressure and try to translate climate-change data into actionable metrics for strategic planning such as capital allocation and risk management.

When considering the impact of climate change, financial executives need to **shift to a much longer time horizon**. Rather than focus on quarterly or year-end reporting, they need to think in periods extending a decade or several decades in the future, according to Rebecca Self, director of sustainable finance at South Pole, a carbon finance consultancy.

CFOs also need to keep in mind that when they extend the forecast duration, they need to **adapt to greater imprecision and**

uncertainty.

“Accountants are used to dealing with very rigorous audit requirements, compliance requirements — very precise sets of reporting,” according to Self, an accountant and former CFO for sustainable finance at HSBC Holdings. “Turning that to climate change and these long time-frame scenarios like the Paris Agreement is really challenging.”

Also, financial executives should **recognize that vulnerabilities from climate change often vary** much more across a company than credit, interest rate, currency and other types of risk. For example, a petrochemical plant near the Louisiana coast is more at risk than company headquarters on high ground.

“Physical climate risks can get very detailed, even down to building type and building construction,” Self said in an interview. CFOs need to delve into “really granular things,” including whether a building has steps from ground level.

Measuring climate risks also requires **taking into account complex indirect costs** to stakeholders such as vendors, employees and neighboring communities.

“As public companies start reporting on ESG, they also get pressure to report more on their supply chain,” Hirth said last month in a webcast hosted by the American Institute of Certified Public Accountants. Investors and customers will ask CFOs “how their supply chain has helped them meet their zero-carbon goals.”

When choosing how to measure their companies’ climate impact, financial executives **must pick from a jumble of inconsistent frameworks** that vary in scope and depth of detail.

Hirth calls the myriad systems “the alphabet soups of ESG reporting.” Some companies simultaneously use as many as four

different frameworks.

Companies in the U.S. and Germany most commonly follow a system created by the Global Reporting Initiative, while their counterparts in the U.K. and France favor the United Nations Sustainable Development Goals, the International Federation of Accountants (IFAC) said in a recent study.

With so many systems in use, climate data, measurement technologies and methods for risk analysis widely vary, according to the CFTC subcommittee.

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“Significant gaps in sectors and across asset classes are impeding not only climate risk management but also aspects of operations and investment analysis that depend on data-informed processes,” the subcommittee said. “Information is not comparable, causing measurement divergences.”

Current measurement systems are especially ill-suited for banks, according to the Bank for International Settlements (BIS). “Existing analysis does not generally translate changes in climate-related variables into changes in banks’ credit, market, liquidity or operational risk exposures or bank balance sheet losses,” the BIS said in a recent study.

The accounting profession has yet to turn climate change data into numbers that accurately gauge the full range of financial risks, according to Arnaud Picut, the global head of risk practice at Finastra, a software provider to financial institutions. “The underlying financial risk across the wider spectrum has been dealt with on the fringe — or not at all.”

Consensus building

Industry and government standard setters aim to build a uniform system for ESG disclosure, but achieving consensus may take some time, Hirth said. “The next couple of years will probably be a little rough as we work towards moving from all these different frameworks to agreeing on something.”

While flagging the inconsistency of reporting methods, IFAC said most companies threaten market stability by failing to subject their sustainability reports to quality independent assurance.

“Low quality assurance is an emerging investor protection and financial stability risk,” IFAC said, adding that only 51% of 1,400 companies worldwide back up their ESG reports with assurance, with many of them relying on consultants rather than professional accountants.

When gauging climate change risks, CFOs need to capture several categories of data from sources outside their enterprise resource planning system.

Financial executives **need to determine which data to capture** and how they will define it. Organizations follow different definitions for even greenhouse gas emissions.

“Some companies have entered into supply arrangements where they have a contractual commitment to report on greenhouse gas

emissions," Wes Bricker, vice chair and assurance leader at PwC, said in an interview.

"What if I've got multiple customers with different definitions?" according to Bricker, SEC chief accountant from 2015 until 2019.

By overcoming the above challenges, CFOs can make progress toward reliably translating climate change data into GAAP and IFRS treatment of goodwill, intangible assets, valuation of inventory and other topics, the accountants and experts in sustainability measurement said.

"At the end of the day, those are the metrics that determine things like your capital management and your profitability," according to Kelly Hereid, director of catastrophe research and development at Liberty Mutual. "If you can understand at what point is climate change so significant that it would change your risk appetite, then you can actually start making decisions based on it."

CFOs can take several steps to turn the obligation to report on climate change risks into an opportunity to gain insights for improving their business, the accountants and sustainability measurement experts said.

1. Favor credible, readily obtainable data

Financial executives should first focus on data that can be captured and confirmed as credible, Bricker said. For example, a CFO can determine a company's greenhouse gas emissions by a combination of verifiable data and estimations, clearly differentiating between the two as in any financial reporting.

"Start with what we know, identify what we don't know, and create estimates clearly identifying what's known and what's been estimated," Bricker said.

Financial executives should also clearly define the several types of data used in gauging climate risk, and ensure definitions align for use both inside and outside the company.

“CFOs can have a really positive impact by helping their internal users, as well as their external stakeholders, focus on what’s important” in curbing the costs of climate change, Bricker said. They “are increasingly spending time with external stakeholders so that they understand reporting by the business, what it conveys, where to locate the disclosure.”

2. Set short-term milestones while pursuing long-term goals

A CFO can ensure measurable progress in shrinking a company’s carbon footprint by defining several near-term milestones across a long-term planning horizon, the accountants and sustainability measurement experts said.

A series of short-term goals can reassure staff, investors and other stakeholders that the company is on course, or help it determine when to make changes to meet its objectives.

“I see CFOs, watching a long-term planning horizon with near-term milestones — extra measurements and accountability — to know whether they’re on track,” Bricker said.

3. Use scenario planning to frame long-term uncertainties

By using scenario planning, financial executives can pursue their objectives for carbon emissions during the coming decades within a high-low range of possible costs — and opportunities.

The analysis “doesn’t pretend to be a perfect vision or forecast of what the future will be,” Self said. “It's about running those different scenarios, running different ‘what if’ questions that are

long term in nature, so they can help inform your decision making today."

4. Rank vulnerabilities, focusing on the biggest

A CFO can limit the cost and period of analysis by focusing on identifying a company's largest physical climate risks — whether drought, flooding, heat, or storm — and prioritizing them across locations and business lines, the accountants and sustainability measurement experts said.

Such analysis, using geospatial and other data, will probably reveal high risks in a few places, Self said, and, in line with the Pareto Principle, show that most risk resides in about 20% of a portfolio.

Companies "should be focusing on where the losses are actually happening" and "where our scientific certainty is the highest," Hereid said this month during a Liberty Mutual panel discussion. For example, estimates of risk from storm surge flooding are comparatively reliable through 2030 and may justify moving warehousing or other operations to higher ground.

By identifying the biggest risks early, a CFO can avert unnecessary research and confidently say, "'I need to do a much deeper dive in this particular location,'" Self said. Without prioritizing "you could almost go on forever, going down to very fine detail."

5. Focus on specific metrics

Among U.S. companies studied by IFAC that publish ESG disclosures, 31% provided reports based on a framework recommended by the Task Force on Climate-related Financial Disclosures (TCFD).

Created by the Financial Stability Board at the request of the Group of 20 nations, TCFD describes 11 types of disclosures across

four areas: governance, strategy, risk management, and metrics and targets.

The TCFD provides only a framework, not in-depth details on how to measure climate risk. For specific measurement guidelines, Bricker recommends that CFOs follow SASB standards, which describe sustainability disclosures for 77 industries across 11 sectors. Forty-eight percent of U.S. companies use SASB, according to IFAC.

CFOs should ride rather than resist the rising tide for ESG disclosures, Hirth said. “You’ve got to tell your story at the end of the day to attract your investors and satisfy your individual stakeholders.”

Financial executives, he said, should view sustainability disclosures “not as a cost but as a way to focus on some factors that make you a better company — that reduces risk, that makes you more attractive to customers, more attractive to employees, gives you a better supply chain.”