THERE'S A STORM COMING: CLIMATE CHANGE

Businesses are entering a period of huge policy and regulatory change as the world steps up its efforts to combat global warming. Actions to address climate change pose significant operational and compliance challenges for companies and those that over promise or lag behind are facing increasing scrutiny.

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THE 1 MINUTE DIALOGUE

- As the world transits to a low-carbon future, more countries are introducing climate change-related regulations
- Companies are likely to face simultaneous regulatory compliance changes across many fronts
- Litigation activism is increasing as advocacy groups advance climate policies and drive behavioral shifts
- Businesses need to use targeted data and analysis to identify potential impacts from developments in climate change risks, regulation and litigation

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The physical consequences of increasing weather volatility are becoming all too apparent. In February 2021, deadly Winter Storm Uri brought record seasonal cold temperatures to parts of the US, testing the infrastructure to the limit and leaving millions in Texas without power or water. As the world battles against coronavirus, extreme weather events like Uri are a timely reminder of the potentially catastrophic threat posed by extreme weather and climate change.

The last seven years have been the warmest on record, with 2020 joining 2016 as the hottest year on record, according to NASA analysis[1]. Despite the reduced economic activity during the pandemic, the World Meteorological Organization[2] states that greenhouse gas concentrations continued to rise in 2020. Carbon dioxide levels have increased by nearly 50% since the Industrial Revolution 250 years ago, while the amount of methane has more than doubled.

Evidence of climate change and its impact continues to mount, with longer and more heat waves, wildfires and hurricane seasons, as well as sea level rises, on the horizon. The 2020 Atlantic hurricane season[3] produced a record-breaking 30 named storms and 12 US land-falling storms. Australia's "Black Summer" bushfires of 2019-2020, the most intense bushfire season to date, occurred in Australia's driest and hottest year on record.

PANDEMIC IMPACT PUTS CLIMATE CHANGE BACK ON THE BOARD AGENDA

For businesses, coronavirus worries superseded climate change concerns in 2020. Climate change ranked as only the ninth most important risk in the Allianz Risk Barometer 2021, pushed down two places in a year dominated by the pandemic. What the pandemic and climate change have in common is that they are both global systemic risks. It is unsurprising then that in 2021, climate change is back on the agenda as a priority.

"Covid-19 is a reminder of the urgent need to tackle climate change and promote sustainability to build greater resilience in the future. It has demonstrated the potential for environmental and climate issues to inflict enormous damage on society," says **Isabel Naumann,** responsible for **Sustainable Finance Regulation at Group Regulatory and Public Affairs at Allianz SE**.

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[1] NASA, 2020 tied for warmest year on record NASA analysis shows, January 14, 2021
[2] World Meteorological Organization, 2020 closes a decade of exceptional heat, December 24, 2020
[3] National Oceanic And Atmospheric Administration, Record-breaking Atlantic hurricane season draws to an end, November 24, 2020

“The election of President Biden is also significant in pushing the sustainability agenda. There is now a period of policy and regulatory change in the US. Having the US back at the international table is critical if the world is to take an aligned approach to climate change.”

The pandemic has changed the context of the debate around climate change, says **Chris Bonnet, Head of Environmental, Social, and Governance (ESG) Business Services at AGCS**. “Like climate change, pandemic risk was previously just an abstract exercise, now it is a risk we experience every day. We also are seeing growing activism and societal pressure on governments and companies to address climate change.”

INTERNATIONAL COMMITMENTS MATERIALIZE AS GOVERNMENT POLICY

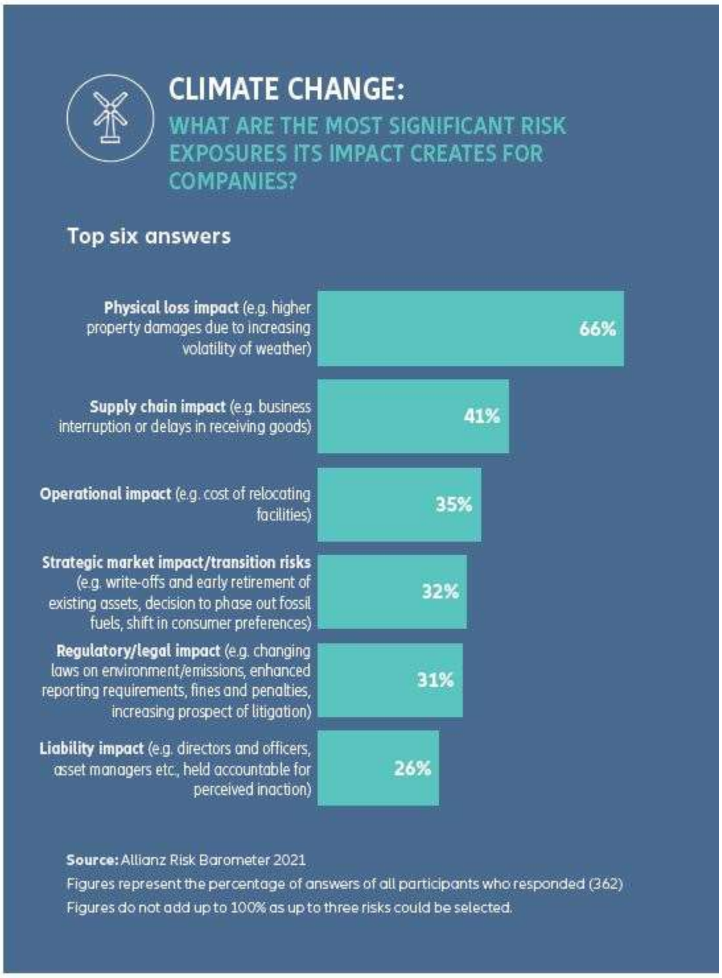
The past decade has seen marked progress on international co-operation and commitments to address climate change and greenhouse gas emissions. Practically every country has signed the Paris Agreement (the US announced in January 2021 it will rejoin), which calls for keeping the global temperature to 1.5°C above pre-industrial era levels in order to avoid the worst of warming. A growing number of countries are also striving to achieve carbon neutrality, or “net zero” emissions, within the next two decades. By early 2021, countries representing more than 65% of global CO2 emissions will have made ambitious commitments to carbon neutrality, according to the United Nations[4].

These commitments are now materializing as government policy, says Naumann: “There is a clear political will to tackle climate change. We see a growing number of climate change-related legislative activity, for the real economy but especially for the financial sector. The idea is to facilitate the transition of the real economy through sustainable finance regulation.”

RISING TIDE OF REGULATION

While the physical loss impact is seen as the most significant exposure from climate change for companies according to this year’s Allianz Risk Barometer respondents, regulatory/legal risk is a rising concern (see graphic below).

[4] United Nations, The race to zero emissions and why the world depends on it, November 2, 2020



As the world transits to a low-carbon future, more and more countries are introducing climate change-related regulations: By mid-2019, more than 1,600 laws and policies relating to climate change had been created across 164 jurisdictions, according to law firm Herbert Smith Freehills[5].

So far, these changes have targeted sectors closest to greenhouse gas emissions, but developments will begin to impact almost all sectors, touching on a wide range of regulation and guidance, including product liability, building codes, supply chains and reporting.

From a policy and regulatory perspective, it is now full steam ahead.

"Businesses are entering a period of huge policy and regulatory change. Companies will face new regulations and standards in the coming years, as well as reviews of existing rules and legislations with sustainability in mind," says Naumann.

COMPLIANCE CHALLENGES AND NEW LIABILITIES

A surge of climate and sustainability-related regulation in combination with inconsistent approaches across jurisdictions and a lack of data availability represents significant operational and compliance challenges for companies, according to Naumann.

With increasing regulation, companies and their directors could face litigation and regulatory action, says Bonnet. While global ESG reporting standards have yet to be agreed, national and regional "hard" legal ESG measures with "teeth" are on the rise, Bonnet explains.

"Climate change-related regulations and ESG requirements make it easier to hold directors and companies to account. Companies closest to fossil fuels will face the highest risk of climate change litigation and regulation, but this is an issue that will become relevant to almost all sectors, from financial institutions to manufacturing and technology."

Companies are likely to face simultaneous regulatory changes across many fronts, which will not always be aligned. "Climate change-related regulatory and legal developments are likely to emerge over time and

[5] Herbert Smith Freehills, 25-Fold rise in climate change related regulation could mean businesses are facing risks to value and reputation, says new report, September 26, 2019

be iterative in nature. The pace of regulatory developments will also be unpredictable, accelerating or slowing with changes in governments and policy," says Bonnet.

CLIMATE CHANGE LITIGATION

The frequency and diversity of legal actions addressing climate change are increasing, including those that are premised on regulatory responses to greenhouse gas emissions and others that arise out of extreme weather events, sea level rise, and other physical impacts of climate change.

Climate change-related litigation might implicate a wide range of issues, including but not limited to potential costs, fines and penalties, prosecution of executives, impacts of valuations and credit ratings and shareholder claims[6].

In total, there were 1,587 cases of climate change litigation in 37 countries between 1986 and the end of May 2020, of which over two thirds were in the US (1,213), Australia (98), UK (62), and EU (57), according to the London School of Economics (LSE)[7]. So far, no company has been found liable for climate change[8], although there are a growing number of cases filed against fossil fuel companies – there are currently at least 40 ongoing climate cases worldwide against "carbon major" companies, mostly in North America, according to the LSE.

"The development of climate change litigation is uncertain, and cases to date have largely been unsuccessful. But the stakes are high. The moment climate change litigation is successful, there would be huge ramifications," says Bonnet.

ACTIVISM AND GREENWASHING

Changes in societal and generational attitudes to climate change are also influencing policy and regulation going forward. For example, since 2019, there has been an escalation in the use of litigation by activists and advocacy groups seeking to advance climate policies, drive behavioral shifts and/or create awareness and encourage public debate, according to the LSE.

Climate change activism has stepped up a gear, says Bonnet: "Campaigns have gone to another level in recent years, and are increasingly aligned and sophisticated. Groups lobby governments and pressure companies to effect change, and they are not afraid to resort to litigation." For example, non-profit law firm, ClientEarth, has gained a reputation for using legislation to hold companies accountable. In September 2020, it secured a major victory by forcing the closure of a giant coal plant in central Poland.

Meanwhile, a number of current lawsuits claim that companies have misrepresented the impacts of climate change, or alleged "greenwashing" where companies make false or misleading ESG claims. A crackdown on "greenwashing" claims could also be on the cards in future with the Task Force on Climate-Related Financial Disclosures, the US Securities and Exchange Commission (SEC) and European supervisors looking into the issue.

Companies that over promise or lag behind on climate change are likely to come under increasing scrutiny, according to Bonnet. "Companies need to ask themselves if promises made are achievable and backed by appropriate action. For example, what does it mean to be 'carbon-neutral'? This will increasingly raise technical and regulatory questions, as well as raising expectations for consumers and investors," says Bonnet.

GETTING AHEAD OF THE CLIMATE MITIGATION AND APAPTATION CURVE

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[6] UN Environment Program's Principles for Sustainable Insurance Initiative, the climate transition, 2020
[7] London School of Economics, Global trends in climate change litigation 2020 snapshot, July 3, 2020
[8] D&O Diary, Climate change litigation threats to directors and officers, November 9, 2020

Companies will only have limited possibility to influence societal and political aspects of climate change. However, keeping a finger on the pulse of the climate change debate will help companies anticipate future policy and regulatory developments.

“This is an issue companies need to keep on top of and to keep in-touch with their peers, customers and suppliers about,” Bonnet says. “The boundaries of what is socially acceptable in terms of carbon-based business models are shifting, and society will want to understand that businesses are contributing to the solution to climate change, rather than being the cause of the problem.”

Businesses need to be proactive in addressing climate change liabilities. “The EU’s climate change and wider sustainability agenda will not be postponed. Companies should start thinking about upcoming requirements and changes in policy and regulation now,” says Naumann. “From a risk management perspective, companies need to consider potential climate change-related liabilities alongside physical and transition risks. By engaging early, companies will be able to prepare for what is around the corner.”

Businesses will need to factor-in future climate change-related regulation and legal developments in their risk management and strategic planning, says Bonnet: “However, just including climate change in the risk register will not be sufficient. Businesses need to use targeted data and analysis to identify developments in climate change risks, regulation and litigation and understand how they could impact their business.”

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BOX 1

KEY EU LEVEL REGULATIONS:

• Sustainability-related disclosure in the financial services sector (application in March 2021)
• EU taxonomy for sustainable economic activities (application in January 2022)
• Review of the Non-Financial Reporting Directive (ongoing)

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BOX 2

EU LEADS THE WAY ON CLIMATE CHANGE REGULATION

Europe is something of a frontrunner when it comes to climate change regulation. At present, there are a number of key policies in development or due for implementation in Europe under the European Green Deal, which enshrines Europe’s greenhouse emissions targets, and the EU action plan for financing sustainable growth. In February 2021, the Commission also adopted a new, more ambitious EU strategy on adaptation to climate change.

“We are now at a tipping point in Europe with the application of first regulatory requirements such as sustainable finance disclosures and the taxonomy for sustainable economic activities kicking in. However, we are just at the beginning of the journey – the integration of sustainability into other areas, such as corporate governance or supply and value chains will follow,” says Isabel Naumann, responsible for Sustainable Finance Regulation at Group Regulatory and Public Affairs at Allianz SE.

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