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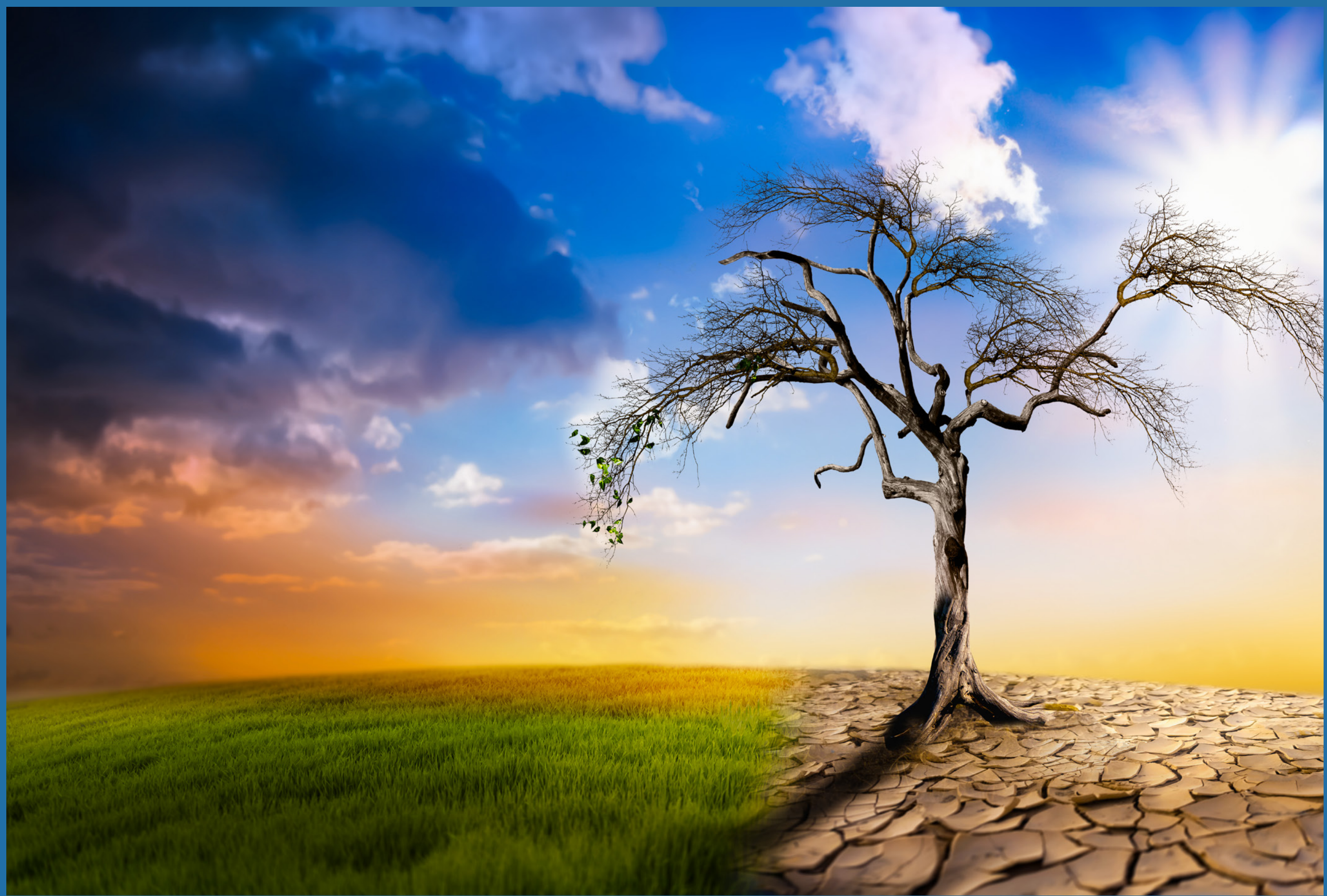
SHORT ARTICLE SERIES

ESG-edu aims to make relevant ESG content available to the various stakeholders for a sustainable future.

We do this through awareness and interactive education programmes focused on retirement fund trustee, management committee member; and fund member awareness and education initiatives, such as this short article.



AN INTRODUCTION TO CLIMATE RISK

Climate change has the potential to cause many disruptions to the financial system. This article provides an overview of the climate risk exposure faced by companies, investors and other stakeholders.

WHY CLIMATE RISK IS IMPORTANT TO INVESTORS AND OTHER STAKEHOLDERS

The effects of climate change will increasingly have a direct impact on the financial returns and sustainability of companies, which is why it is becoming imperative for both corporates and investors to integrate climate-related risks into their strategic and operational processes. In this vein, companies are also becoming increasingly obligated to report on their climate risk exposure to their investors and other stakeholders – such as regulators or government, clients and employees.

Furthermore, climate change presents a number of material risks for both corporates and their investors, and companies need to provide information as to what these potential material risks are and how they will be managed. Insufficient information about climate risk from companies can lead to the mispricing of assets, misallocation of capital, and asset price bubbles, presenting additional risk to companies, investors and society at large.

RISKS RELATED TO CLIMATE CHANGE

PHYSICAL RISK

Relate to the physical impacts that can come about as a result of climate change.

Climate change increases the frequency, intensity and unpredictability of physical risks, such as extreme weather events. The short-term financial implications of these events include damage to property, infrastructure, livelihoods and even loss of lives. Longer-term effects include reduced agricultural productivity as a result of temperature changes, and threatened marine ecosystems as a result of warmer and more acidic oceans.

TRANSITION RISK

Arise as a result of the transition to a low-carbon economy, spurred on either by regulation or changing consumer preferences.

Transition risks arise when financial institutions fail to incorporate the gradual shift from carbon-intensive to greener business models into their planning, which could result in the risk of having stranded assets in their portfolios. As the transition to lower-carbon economies progresses, carbon-intensive companies are likely to suffer from reduced profits, operational and/or regulatory disruptions to their operations, as well as reduced investor interest.

As more companies, sectors and markets are negatively impacted by both physical and transition climate risk, this could cause strain on the financial system as a whole, resulting in job losses, as well as increased levels of poverty, inequality and economic and political instability.

Further impacts of climate risk

- **Knock-on effects of physical risks**, such as falling crop yields, resource shortages, supply chain disruption, as well as migration, political instability or conflict
- **Policy:** financial impairment arising from local, national or international policy responses to climate change, such as carbon pricing or levies, emission caps, border tax adjustments or subsidy withdrawals
- **Liability:** financial liabilities, including insurance claims and legal damages, arising under the law of contract, tort or negligence because of other climate-related risks and impacts
- **Reputational:** risks affecting businesses engaging in, or connected with, activities that some stakeholders consider to be inconsistent with addressing climate change
- **Market:** input and product markets will evolve as the cost of GHG emissions are internalised and consumer preferences for carbon-intensive goods change

This article is the first in a series derived from the Special Edition ESG-edu publication, *Climate-related financial disclosure: Aligning South Africa to global best practice.* The publication and short article series is supported by South Africa-UK PACT. You can read and download the full publication, at no cost, here: Read the publication

About UK PACT | Supporting transformational climate change projects worldwide
In July 2020 The UK Partnering for Accelerated Climate Transitions programme (UK PACT) launched the South Africa-UK PACT country programme to support action in just transition pathways and a low-carbon economic recovery. For more information on South Africa-UK PACT and the projects being funded in South Africa, visit www.ukpact.co.uk/country-programme/south-africa

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