How CFOs can help companies weather climate change

As the environmental impact of climate change becomes more and more visible, finance leaders around the world are on the front lines of calculating the risks and bolstering their companies' financial resilience in the midst of such ongoing threats.

Both the North American CFO Signals™ survey for the fourth quarter of 2019[1] and the Autumn 2019 European CFO Survey[2] asked finance executives what their companies are doing to address climate change risks, to what extent different stakeholders are pressuring them to act, and what specific steps their companies have taken. Among North American CFOs, more than 70% said their company is under at least moderate pressure to act from at least one stakeholder group. Sixty-one percent of European CFOs (representing 19 countries) reported that they feel pressure to act from three or more stakeholders.[3]

The increasing frequency and severity of climate-related disasters has raised the specter of unforeseen losses. By the US government's count, the country endured 14 separate billion dollar (or more) weather and climate disaster events in 2019, at a total cost of $45 billion. For CFOs, such events indicate the high potential impact that climate change may have on future operations and financial returns—whether in the form of physical risks (rising temperatures, lower crop yields, etc.), as a result of the transition to a low-carbon environment (e.g., investments in updated equipment), or of having to accommodate a shift in consumer preference.

In this issue of *CFO Insights*, we'll explore the multitude of forces pressuring companies to act now on climate change and examine some of the ways CFOs can fortify their companies against the expected economic damage it could generate.

A gathering storm

CFOs' growing focus on mitigating climate-change-related risks is not just a reflection of their concerns about how changing precipitation patterns could affect sectors such as agriculture and insurance. Beyond the dramatic, most publicized scenarios—damaged farmland, disrupted supply chains, mass migrations—sits a mounting body of data suggesting that nearly all sectors could feel the effects. CDP Global, a UK-based organization, last year reported that a group of the world's biggest companies,

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representing nearly $17 trillion in market capitalization, have valued their business' climate risks at almost $1 trillion. Around $500 billion of costs were rated as likely to virtually certain, with higher operating costs linked to legal and policy changes making up a significant risk.[5]

Such numbers may speak for themselves—but perhaps not as loudly as conditions might warrant. A growing breed of investors is advocating for a large-scale reallocation of capital toward sustainability-sensitive investments. The types of external forces of change that are bearing down on CFOs include the following:

- **Investment firms integrating climate change into their decisions**. In January, BlackRock Chairman and CEO Larry Fink wrote a letter to his portfolio CEOs stating that "climate change has become a defining factor in companies' long-term prospects" and declaring that "we are on the edge of a fundamental reshaping of finance."[6] The world's largest investment management firm vowed "to place sustainability at the center of our investment approach"—signaling that boards of its portfolio companies can expect to be questioned. In addition, State Street Global Advisors issued a letter vowing to "take appropriate voting action" against board members at big companies in Australia, France, Germany, Japan, the UK, and US, who lagged in terms of various environmental, social, and governance (ESG) metrics and had no clear plans to improve.[7] Elsewhere, one of the UK's biggest fund managers, Legal & General Investment Management (LGIM), has also been outspoken on climate change. Its Future World funds are governed by a Climate Impact Pledge, enabling it to exclude companies over weak climate disclosures and other related issues.[8] Investor-led initiatives include Climate Action 100+ and the Portfolio Decarbonization Coalition, which is focused on driving reductions in greenhouse gas (GHG) emissions.
- **The push to disclose climate-related financial risks**. As long ago as 2015, The Financial Stability Board formed the Task Force on Climate-related Financial Disclosures (TCFD). The organization has since released recommendations to standardize how companies assess and disclose their climate-related risks.[9] Meanwhile, the Sustainability Accounting Standards Board (SASB), a San Francisco-based non-profit organization, has developed a set of 77 industry-specific sustainability accounting standards to help public corporations disclose material ESG information to investors for decision-making. Additionally, the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), a Paris-based consortium of about 50 central banks and other institutions, recently issued its recommendations for managing climate-related risks to foster a greener financial system.[10] In January, Federal Reserve Chairman Jerome Powell said that the Federal Reserve would "probably at some point" sign on as a member. Another notable initiative includes the Frankfurt-based Value Balancing Alliance, which seeks to develop a globally recognized standard for valuing the social and environmental externalities of corporate value chains. It has gathered significant political momentum, is backed by the Organization for Economic Cooperation and Development (OECD) and the European Commission, and is supported by the Big Four professional services organizations. Such support makes it highly probable that the alliance's suggested approaches will form the basis of forthcoming regulation regarding the integration of externalities into corporate accounting and steering.
- **Prince Charles and the Sustainable Markets Initiative**. At the World Economic Forum in January 2020, long-time sustainability advocate Prince Charles characterized global warming and climate change as "the greatest threats that humanity has ever faced." At Davos, he also launched the Sustainable Markets Initiative, aimed at bringing together leading international figures to find ways to "decarbonize" the global economy.[11]
- **Growing stakeholder engagement**. In this age of accountability, it's not sufficient for companies to only enrich shareholders, as was acknowledged by the Business Roundtable's recently revised Statement on the Purpose of a Corporation, which was signed by more than 180 CEOs.[12] Concerned consumers now view a company's awareness—and measurement—of key issues, such as diversity and climate change, as integral to exhibiting corporate citizenship.

What all of this adds up to is an increasing intensity—some of it beneath the surface—that could come to a boil if triggered by certain events. In the face of more disruptive weather disasters, climate risk is swiftly rising to the top of many companies' agendas.

An imperative to act

It is fair to say that many CFOs are already feeling the pressure. Large proportions among both European CFOs of big companies (59%) and North American CFOs (47%) report feeling at least moderate pressure emanating from their employees. And the number of CFOs who said that shareholders/investors are applying that same level of pressure amounted to 52% of European CFOs and 37% of those based in North America (see Figure 1).

There were stark differences in some stakeholder categories. For instance, 19% of North American CFOs said they were feeling no pressure from board members/management, while just 7% of their European counterparts claimed the same absence. While about two-thirds (67%) of European CFOs felt at least moderate pressure from clients/customers, not even one-half (43%) of North American finance leaders felt at least moderate pressure from that direction. A significant disparity was also present between the two CFO groups regarding regulators/government: 51% of large-company European CFOs sensed at least moderate pressure coming from those stakeholders, while just 29% of their North American counterparts felt the same.

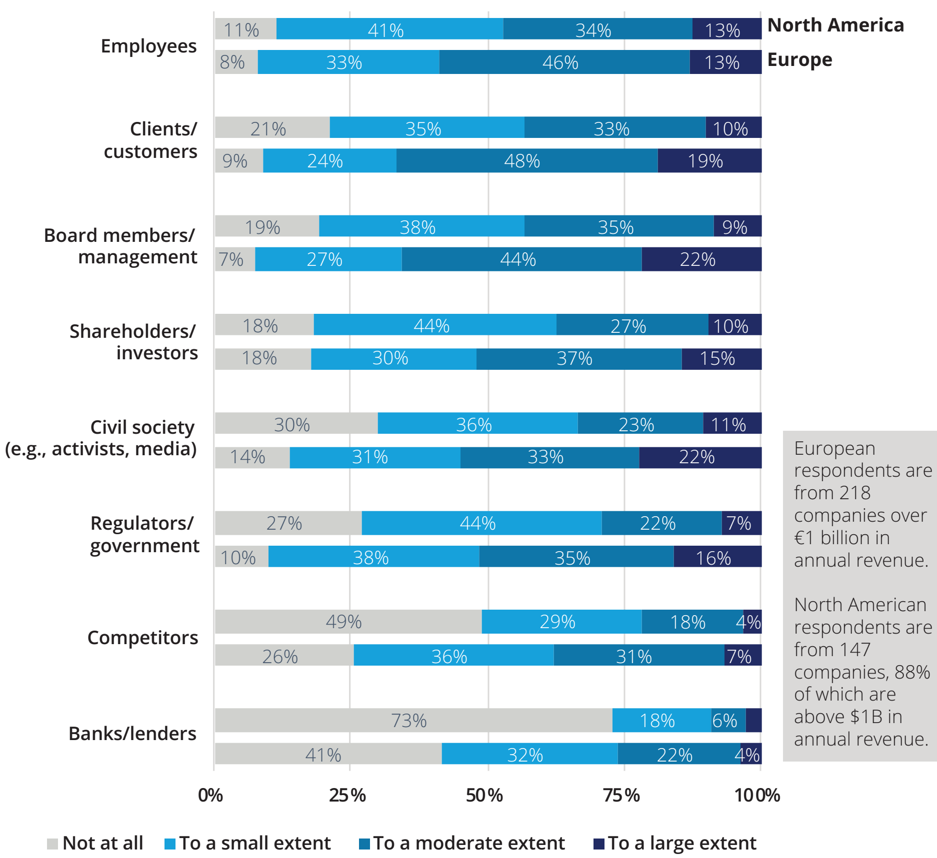
It's worth noting that European regulators and policy makers have been framing climate risk in terms of potential economic advantage for much longer than their US counterparts have—and setting ambitious targets for slashing carbon emissions. Guided by the EU since 2017, more than 60 countries and cities have adopted net-zero carbon emission targets, with the UK and France having enshrined those targets into national law.[13] In the Autumn 2019 European CFO Survey, 38% of European CFOs said they have already reduced carbon emissions in the upstream supply chain and/or in logistics. Among North American CFOs that figure was 24%, according to CFO Signals.

Those are not the only actions CFOs have taken (see sidebar, "Several degrees of separation"). In fact, more than 90% of North American finance chiefs said their company has taken at least one action in response to climate change, with an average of 3.7 actions. Specifically, three actions drew more than one-half of the North American responses: increased efficiency of energy use (80%); inclusion of climate risk monitoring and management in corporate governance processes (53%); and use of energy-efficient or climate-friendly machinery, technologies, and equipment (52%).

By contrast, only 43% of European respondents said they had included climate risk in their corporate governance processes. On the other hand, 80% reported increasing the efficiency of energy use, while more than one-half (55%) said they had taken the step of using energy-efficient or climate-friendly machinery, technologies, and equipment. A slightly lower proportion (53%) reported shifting operational energy usage toward renewable energy sources. Almost half (48%) said they were developing new climate-friendly products or services. Whether companies are doing so, it turns out, may be connected to where the pressure on them to act originates. For instance, 42% of all European companies that felt more than moderate pressure from their clients are developing new products, according to the Autumn 2019 European CFO Survey. Only 21% of those who did not feel client pressure reported taking that action.

Figure 1. Stakeholder pressure to act on climate change

To what extent does your company feel pressure to act on climate change from your stakeholders? Percent of CFOs selecting each level of pressure from each stakeholder group



Source: European CFO Survey Autumn 2019, Deloitte University EMEA CVBA, 2019.

Several degrees of separation

Large-company CFOs in Europe and North America share a concern about climate change—but differ on actions to prioritize.

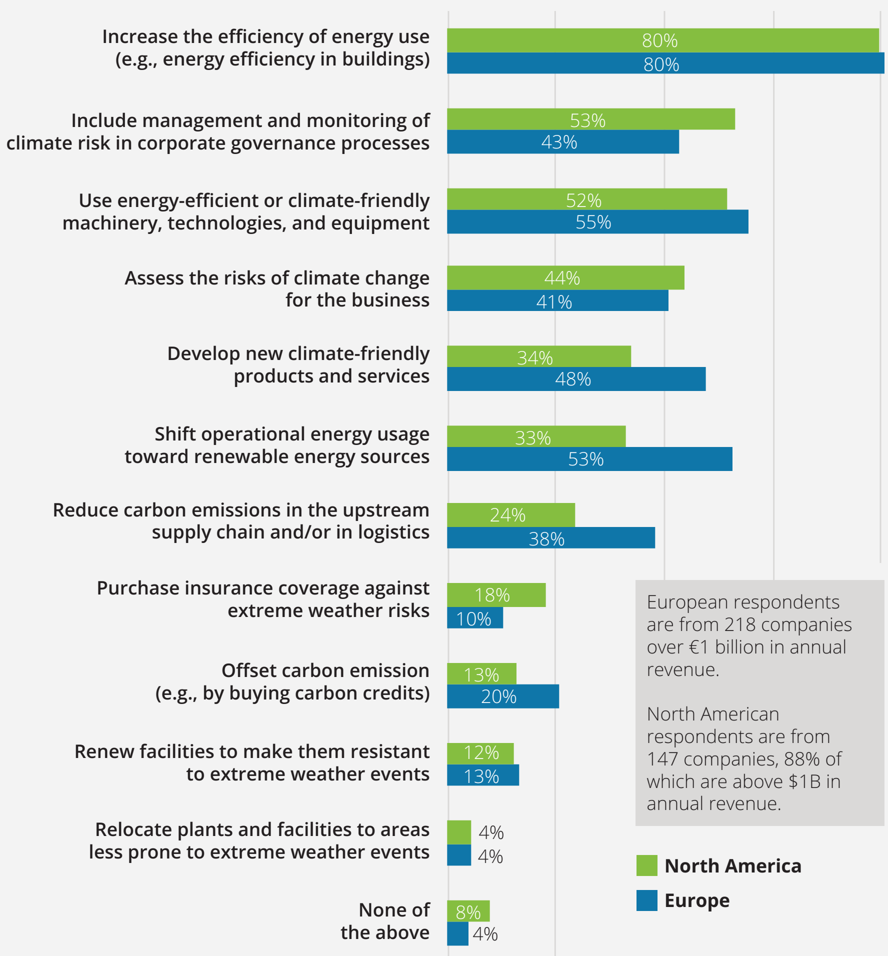
CFOs from both North America and Europe share the experience of feeling pressure from internal and external stakeholders to act on climate change. But they demonstrate differences when it comes to prioritizing which steps to take.

In separate surveys,[14] identical proportions of large-company respondents in Europe (defined as those with annual revenues of €1 billion or more) and CFOs in North America—80% in each case—said one measure they had taken was to increase energy efficiency. Comparable percentages also reported using energy-efficient or climate-friendly machinery, technologies, and equipment (55% among European CFOs versus 52% among their North American counterparts). For European CFOs, such measures often benefit from government incentives and offer long-term cost reductions.

While 41% of European CFOs have assessed the risks of climate change for the business, 44% of those in North America have also done so. Overall, however, large European companies appear to be taking more action related to climate-friendly offerings, renewable energy, and carbon emissions; North American businesses, in comparative terms, appear more focused on building climate change into governance (see Figure 2).

Figure 2. Actions taken in response to climate change

Is your company taking or about to take any of the following measures to manage, mitigate, and/or adapt to climate change? Percent of CFOs selecting each measure



Source: European CFO Survey, Autumn 2019.

Taking a structured approach to the issue, and integrating management and monitoring of climate risk in corporate governance processes—which 53% of North American CFOs have done, compared with 43% of European finance leaders—may reflect deeper concerns. Among large European companies, the survey found that businesses feeling the pressure to act on climate change from three or more stakeholders were more likely to take a more systematic approach. In the European survey, that encompassed 61% of large-company respondents.

In part, what's likely helped hoist climate change to a higher spot on European CFOs' agendas is the continued growth of sustainable investing on the continent. In a 2019 survey[15] of 650 institutional investors responsible for $25.4 trillion in assets, 63% reported that their sustainability investments in Europe had grown over the preceding five years, compared with 48% who could say the same about North America. According to the survey, Europe also boasts the lowest proportion of respondents not investing in sustainable funds (14%).

Such investor acceptance may help explain why a higher proportion of European CFOs feel increased latitude in taking any number of steps, from developing new climate-friendly products and services to shifting operational energy usage toward renewable energy sources to purchasing insurance coverage against extreme weather risks to offsetting carbon emissions by, for instance, buying carbon credits. Such shorter-term wins may be preludes to tackling structural change.

Of course, the US and Europe have a tradition of taking divergent approaches, dating from the US rejection of the 1997 Kyoto Protocol[16] to its 2017 reversal regarding participating in the 2015 Paris Agreement.[17] But as stakeholder scrutiny grows, finance leaders in both Europe and North America will likely feel greater urgency to integrate climate change risk into business planning in as many ways as they can.

Rising to meet climate opportunities/ challenges

There are additional steps CFOs should consider to position themselves to seize growth opportunities driven by climate change. For example:

1. Look beyond the short-term. While improved energy efficiency and reductions in carbon emissions are laudable and cost-efficient, CFOs should also consider evaluating the longer-term structural risks. In the not-too-distant future, changes in the climate could start to affect supply chains or the availability and quality of raw materials. By taking a broader strategic view and incorporating climate change into their forecasts, finance executives can improve the company's long-term viability.

2. Make climate change a board priority. CFOs need to ensure that directors understand that climate change could have a material impact on the business. Mitigating that risk may mean integrating climate change strategy into the board's mandate, as well as building competence and assigned oversight within the board. Oversight needs to be consolidated, elevating it to become part of the board's responsibilities.

3. Maintain a robust R&D budget. Meeting the challenges of climate change can drive innovation in new products/services, as well as in business processes. In past years, companies seeking to hedge against the high cost of oil have generated solutions, such as software that can route trucks with greater efficiency. The process of decarbonizing the global economy—the Paris Climate Agreement sets ambitious targets for limiting global warming—will not only result from incremental improvements in fuel or energy efficiency. It will require breakthroughs in areas such as battery technology.

4. Adopt environmental accounting and reporting tools. By integrating a sustainability-reporting tool into their company's ERP, CFOs can better measure—and manage—their company's environmental performance against its established targets. Automating the process of collecting environmental data, including greenhouse gas emissions, can also equip finance leaders to optimize trade-offs between climate-related risks and opportunities. It can also expedite the process of reporting the company's environmental impact, reducing regulatory risks.

5. Incorporate climate change throughout the business. CFOs should consider promoting robust climate-change disclosure so that investors can get an accurate reading on the company's progress toward its related goals. They may also support changes in areas such as executive compensation, where a link to climate-change mitigation would likely be effective.

CFOs can also help drive a refreshed investor/stakeholder narrative, one that draws together risk assessment, governance, and strategic thinking and ensures that it is coherently represented within financial statements. As financial statements both look forward in their narrative while reporting a recently historical financial position, clearly representing the organization's position and actions on this complex topic can be a significant challenge that CFOs are well placed to help address.

Modern finance executives are keenly alert to the need for a company to preserve its reputation—as many have witnessed the market's capacity for punishing companies that are deemed as having behaved less than respectfully (whether toward the environment or their own employees). Climate change response could increasingly become crucial to reputation-maintenance. Calculating the dollars at stake should make it clear that the relationship between climate change and finance has left the realm of the theoretical. While images of depleted oceans and expanding deserts can seem distant and fuzzy, the risks related to climate change are becoming clearer and clearer.

Endnotes

1. "Downturn concerns dampen 2020 revenue, earnings, investment, and hiring expectations," North American CFO Signals Survey, Q4 2019, US CFO Program, Deloitte LLP.

2. "Into the woods," European CFO Survey Autumn 2019, Deloitte University EMEA CVBA, 2019.

3. North American respondents represented 147 companies, 88% of which posted more than $1 billion in annual revenue; among European respondents, the survey consisted of 218 respondents whose companies generated annual revenue of more than €1 billion.

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6. "A Fundamental Reshaping of Finance," BlackRock, January 14, 2020.

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11. "UK's Prince Charles says climate change is humanity's greatest threat," Reuters, January 22, 2020.

12. "Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,'" Business Roundtable press release, August 19, 2019.

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Contacts

Mike Barber
Partner, Sustainability Practice Leader
Deloitte UK
mbarber@deloitte.co.uk

Julian Blohmke
Manager, Sustainability Services
Deloitte Germany
jblohmke@deloitte.de

Michela Coppola
Senior Economist, European CFO Survey Lead
Deloitte Germany
micoppola@deloitte.de

Greg Dickinson
Managing Director, North American CFO Signals Survey
Deloitte LLP
gdickinson@deloitte.com

Eric Dugelay
Partner, Sustainability Services, Deloitte France
Member, Task Force on Climate-related Financial Disclosures
edugelay@deloitte.fr

Wolfgang Falter
Partner, Strategy & Business Design
Deloitte Germany
wfalter@deloitte.de

Olivier Jan
Partner, Sustainability Practice, Deloitte France
Sustainability Leader, Deloitte Global
ojan@deloitte.fr

Ajit Kambil
Global Research Director, CFO Program
Deloitte LLP
akambil@deloitte.com

Thomas Krick
Director, Head of Sustainability Services
Deloitte Germany
tkrick@deloitte.de

Kristen Sullivan
Audit & Assurance Partner
Americas Region Sustainability Services Leader
Deloitte & Touche LLP (US)
ksullivan@deloitte.com

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Deloitte *CFO Insights* are developed with the guidance of Dr. Ajit Kambil, Global Research Director, CFO Program, Deloitte LLP; and Lori Calabro, Senior Manager, CFO Education & Events, Deloitte LLP. Special thanks to Josh Hyatt, Manager/Journalist, CFO Program, Deloitte LLP, for his contributions to this edition.