Five misconceptions about climate-related risks

And how you should look at them

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Figuring out progress

You often don't use traditional financial metrics to measure progress. Instead, society values organizations based on how they deal with things like algorithms, privacy, inclusivity and sustainability. But how can you tell you're on the right track? Not all growth is progress. We help organizations with the themes that society values most. Like climate risk.

People-driven progress

Introduction

Climate change is a hot topic. Not only for citizens, but also for the corporate world. The Paris Agreement, and growing public and regulatory pressure, brought the matter to the top of the corporate agenda. Companies understand that managing the risks and opportunities arising from climate change now is crucial to becoming future-proof. However, this is not yet a majority.

Over the past years, we have heard a number of arguments to not act on climate-related risks, which essentially are misconceptions. In this document we will clarify the **five most common and important ones,** to help you understand the risks.

Five misconceptions about climate risk

1. **'Our company will not be hit by climate-related risks,** neither in a 2°C scenario nor in a 4°C scenario'
2. **'Our company already has a sustainability plan and net-zero target,** we cover the climate-related risks with this'
3. **'Our risk management department looks at all risks,** including climate-related risks'
4. **'Climate change is such a long term and complex matter,** we'll see it when we get there'
5. **'Taking actions** on climate change only cost money'

What is the Paris Agreement?

Reached in December 2015, almost 200 countries pledged to control greenhouse gas emissions to limit global warming to 2°C or lower by the year 2100 from pre-industrial levels. The 2°C scenario is widely seen as the global community's accepted limitation of temperature increase to avoid significant and potentially catastrophic changes to the planet.

What is climate change?

Climate change stems from the world continuing to warm as a result of increasingly concentrated greenhouse gases in the atmosphere. Global warming is causing temperatures to increase, sea levels to rise, and more frequent and intense extreme weather events to happen.

What are climate-related risks?

Climate-related risks refers to the potential negative financial impacts of climate change on an organization and usually relate to:

Risks related to the transition to a lower-carbon economy (e.g. policy, legal, technology, and market changes to address mitigation and adaptation requirements related to climate change).

Risks related to the physical impacts of climate change, acute or chronic (e.g. changing weather patterns, flooding, drought, hurricane, increase in temperature).

These risks are systemic and threaten the stability of financial markets and will become everyone's and every company's problem at some point if not managed timely.

Misconception #1
'Our company will not be hit by climate-related risks'

Some companies believe they will not be affected by climate change at all, which they justify by the fact that their industry is not carbon-intensive. Or they believe that the physical changes will not be severe for the regions in which they operate. They are wrong, simply because companies do not acknowledge the correlation between the negative impacts they already face in their day-to-day operations and climate change.

In fact, many companies have already been affected by the impact of climate change. More frequent and severe weather events are damaging infrastructure and disrupting supply chains. Transition to a lower carbon economy comes with new policies, regulations and rapid changes to market dynamics, with consequences for companies in different sectors. Some oil and gas companies are already facing lawsuits over their contributions to climate change. In addition, some companies, like the chemical multinational company BASF, already faced a financial damage of EUR 250 million due to extreme drought. The drought affected the water level in the Rhine river so badly, that ships couldn't navigate the river and BASF couldn't use the river as a source of cooling water for chemical reactors.

Events like these – due to climate change – are increasing and will become real for many organizations. That's why it's so important companies acknowledge the issue and anticipate the effects today. For example by rethinking and rearranging their supply chain. Or, in the case of BASF, by reducing its dependency on cooling water from the River Rhine to mitigate the risk of low water levels. Climate-related risks are thus very broad, and cannot be mitigated by just looking at carbon emission reduction. Neither in a 2°C scenario, nor in a 4°C scenario.

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Misconception #2 'Our company already has a sustainability plan'

In recent years, many countries and companies have developed a sustainability plan and released bold new climate commitments, a step in the right direction to halve CO_2 emissions by 2030 and reach net-zero CO_2 emissions by 2050 in order to limit global warming to 2°C or lower above pre-industrial levels.

It is sometimes believed that having a sustainability plan and a net-zero target means the company is prepared for climate-related risks. This could be true if companies are active in a carbon-intensive industry, like oil and gas. Decreasing their emissions would not only be the right thing to do for society, their reputation and the reputation of their sector, it would also reduce the risk of having to pay higher operating costs as a consequence of a future carbon price or tax.

However, if an individual company achieves its targets, but the rest of the world still is on a 4°C path, the company will still be at risk of climate change in a 4°C world. Maybe less so from carbon taxes, but surely from other climate-related effects – such as price volatility of raw materials due to increased competition and resource scarcity, or social issues in the value chain due to disproportionate adverse impact of climate change in vulnerable regions.

When assessing climate-related risks (and opportunities) one should take the opposite view of impact: what are the effects beyond carbon taxes that may impact the financial flows and capital of the company? A real estate or food retail company with net zero emissions could still be at risk of flooding in certain coastal areas or subject to changes in consumer diets.

Don't get us wrong: a sustainability strategy and reduction of CO_2 emissions are certainly a step in the right direction. However, it doesn't cover the complete picture.

Misconception #3 'Our risk management department looks at all risks'

Risk management departments identify and monitor risks of the company, on the basis of a very structured process. However, we see risk management departments struggling with getting grip on climate risks because of these challenges: the longer time horizon and the systemic disruption.

Longer time horizon

The risk management process often looks one year ahead, sometimes one to three years and occasionally one to five years. But climate-related risks often present themselves in the long term.

Systemic

The occurrence of these risks could cause a chain reaction of events, disrupting our financial system, economies and business-as-usual activities, which makes them difficult to understand, identify and analyze. Refer to our illustrative example of a drought in Morocco showing the interconnection between climate-related risks and other risks.

These challenges make traditional risk management inadequate. Risk managers traditionally look at the likelihood and impact of an identified risk. Scenario analysis, on the other hand, can be considered a form of risk management, but it has distinctly different characteristics, especially with regard to its long-term outlook (>10 years) and acknowledgement of the impact of volatile events. Scenario analysis allows companies to understand the climate-related risks relevant to their business and how they may evolve over time.

Read more about defining scenarios in our paper: Looking forward to a rising temperature? Practical insights for a climate risk scenario analysis.

Misconception #4
'Climate change: we'll see it when we get there'

As human beings, we have the tendency to overestimate short-term threats and underestimate complex, long-term threats. These cognitive biases make it difficult to address long-term challenges that now threaten our planet, like climate change. This could explain that there are still many organizations that are missing the sense of urgency or don't know exactly how or where to start.

It is important to prepare for the consequences of climate change and to strengthen the agility of your company. The reason again lies in the time horizons. An investment or strategic decision now could commit the company to a time horizon in which the effects will play out. With a long-term investment horizon in mind, it is important to include climate-related risks and opportunities in current decision making – to make the right choices in investment, strategy, financing and product innovation. This will enable the company to be prepared once the impacts from climate change are shown more frequently and/or severely.

In addition, due to increasing attention and pressure to act from a broad range of stakeholders, inaction is no longer an option. Climate change is transforming how consumers, employees and shareholders evaluate companies and interact with them. With global efforts converging to reduce carbon-intensive activities and incentivize low-carbon technologies, investors are increasingly demanding forward-looking metrics to assess portfolio risk beyond traditional financial measures and simple carbon footprints. In addition, central banks and other supervisory authorities are now considering climate change as a risk to financial stability.

Companies don't only need to measure their exposure to climate-related risks and subsequently manage them, but also incorporate them in their strategic plans. Failure to do so could undermine the sustainability and resilience of their business. If, as a company, you don't make a decision about climate change, climate change will make the decision for you.

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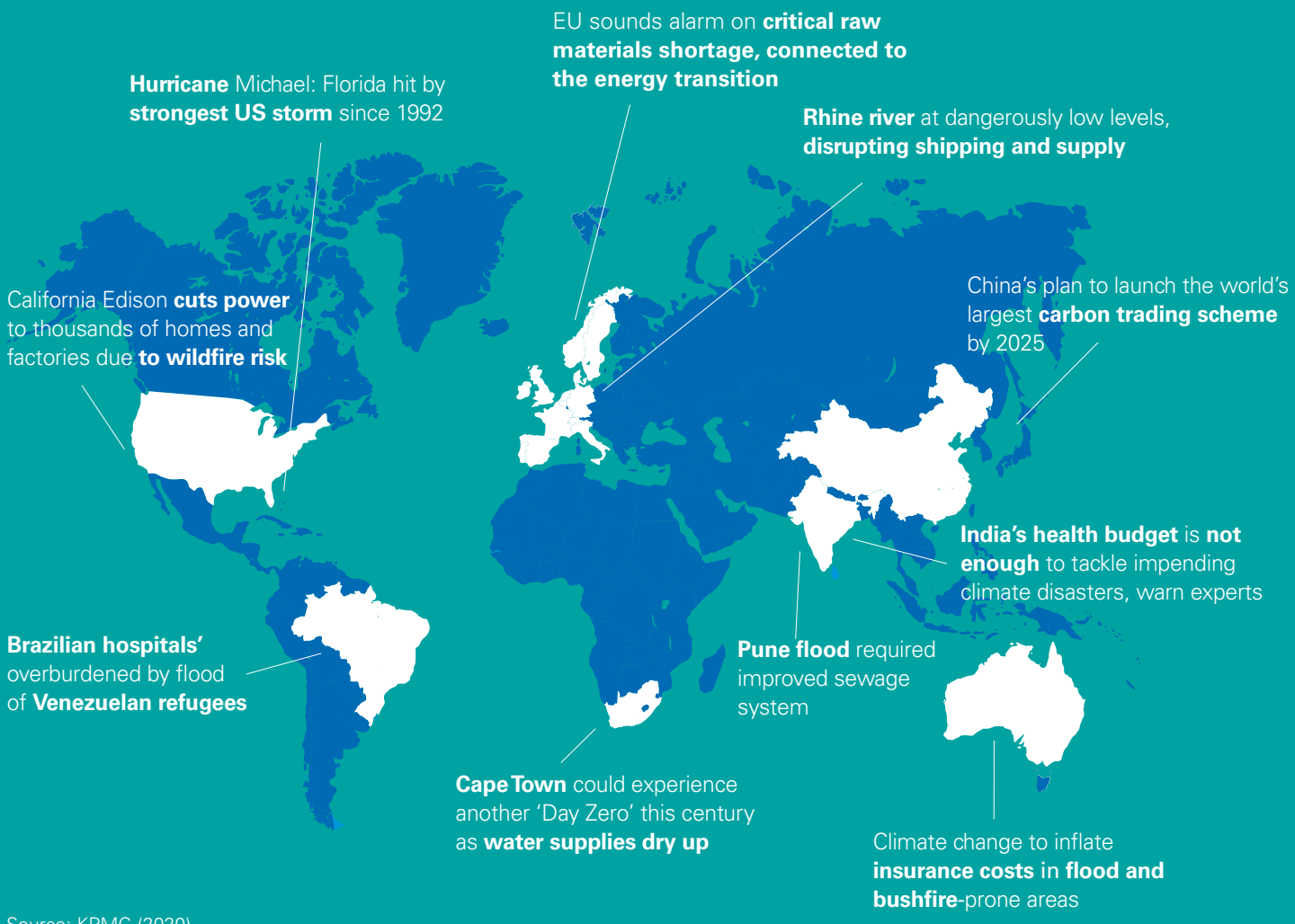
See a few examples below that are already showing the impacts of a changing climate:



Source: KPMG (2020)

Misconception #5
'Taking actions on climate change only costs money'

Some organizations believe that mitigating climate-related risks and taking action on climate change, only cost time and money. Let's be clear: mitigating risks will indeed cost money, but failing to act will be even more expensive in the future. The current debate however sometimes focuses too much on the risks. Not everybody sees the opportunities that will arise: innovation and technology development, new products, retaining talent and being seen as a leader.

Companies that take timely and appropriate (mitigating) actions, could:

Reduce their costs as companies can improve their resource productivity (for example by increasing energy efficiency).

Unlock new market opportunities & foster competitiveness climate change can spur innovation, inspiring new products and services which are less carbon intensive or which enable carbon reduction by others.

Become future-proof companies can enhance the resilience of their supply chains, for example by reducing reliance on price-volatile fossil fuels by shifting towards renewable energy or circular products.

Let us take to examples: a windfarm company, which understands how climate change will impact weather patterns, including wind directions and intensity, could make better investment decisions or enter new markets.
But even the traveling landscape will change. A travel or real estate company that understands how climate change will affect the location of their travels or properties will be in a better position to make strategic decisions and stay ahead of peers or competitors.

Acting now to prepare your company for climate change will definitely pay off in the future. It will not only help your company to unlock new market opportunities and create lasting commercial advantages, it will also help avoiding potentially catastrophic climate change in the second half of the century.

> Mitigating risks will indeed cost money, but failing to act will be even more expensive in the future

Contact

We help organizations with the themes that society values most. Like climate risk. So real progress takes shape.

Knowing how we can bring your organization further? Please don't hesitate contacting us.

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