Climate-related transition risks: Meeting the challenge

July 2024 | by Nicholas Daly, Michelle Lin, Autumn Liu, Orest Pazumak, and Safa Waqar

Why do transition risks matter?

Increasingly, organizations are having to contend with two types of climate-related risks: transition risks and physical risks. Transition risks arise as national economies and organizations themselves transition to a lower greenhouse gas (GHG) future, whereas physical risk is typically the result of damage to physical assets from climate-induced extreme weather events, such as flooding, extreme temperatures, or wildfires. Transition risks may be the result of regulatory changes, government incentives and guidance, investor demands, or shifting consumer preferences. A few examples of transition risks include a range of challenges from carbon pricing or reputational perception by market participants. The more ambitious the implementation of emission-reducing policies, regulations, standards, or targets, the greater the transition risk for organizations.

Financially quantifying transition risks through climate scenario analysis can generate insights for enterprise-wide business strategy, planning, and implementation of climate-smart initiatives that can drive climate-resilient growth. Even if regulations have not yet been implemented, organizations that proactively mitigate potential risks and associated costs may be able to take advantage of cost-saving or revenue enhancing market opportunities, while also concretely improving their brand reputation amongst their customers, industry peers, and board members. Disclosing their transition risk mitigating plans, initiatives, and investments may improve transparency amongst key internal and external stakeholders, engendering trust and while also improving their reputation.

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Understanding transition risks

Transitioning to a low carbon economy entails changes in climate policy, innovations in technology, and shifts in consumer preferences to address mitigation and adaptation. Transition risks are generally grouped into four core categories: (1) policy and legal, (2) technology, (3) market, and (4) reputation. These disclosure categories are leveraged by other regulatory agencies both on local and national levels. Policy and legal risks examples include carbon pricing and reporting obligations, mandates on and regulation of existing products and services, and exposure to litigation. Technology risks encompass such issues as substitution of existing products and services with lower emission options and costs associated with investment in new technologies. Market risks include changing customer behavior, uncertainty in market signals, and increased cost of raw materials. Reputation risks consider shifts in consumer preferences, increased stakeholder concerns or negative feedback, and stigmatization of the sector. The effect and nature of these transition risks vary depending on how resilient an organization is to climate change, and as such, understanding transition risks is a key first step in building resilience.

Improving transparency and trust through analytics and disclosure

With changes to the regulatory landscape, consumer preferences, or investor expectations, companies and whole economic sectors may increasingly face transition risks. Many global disclosure rules and standards builds upon the Task Force on Climate-Related Financial Disclosures (TCFD), include the disclosure and reporting of transition risks with respect to an organization's financial statement, such as income statement, cash flow statement, and balance sheet.

The value of this information is that it creates transparency for key stakeholders, generating trust internally and externally that the organization is positioning itself to drive climate-resilient business growth. This financial disclosure and quantification of transition risks allows investors, lenders, rating agencies, and insurance underwriters to better understand how climate-related risks and opportunities are likely to affect an organization's future financial position and ability to remain profitable in the face of climate change. Some examples of valuable information in these consolidated financial statements are an increase in operating costs for an organization (e.g., higher compliance costs), write-offs and early retirement of existing assets, or an increase in price-driven production input (e.g., energy or water) and output (e.g., waste treatment) costs.

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Other client considerations

Beyond the regulatory reporting frameworks included in the U.S., or in other jurisdictions such as the Corporate Sustainability Reporting Directive (CSRD) in the EU, organizations have both costs and opportunities associated with incorporating a transition risk framework. Although many S&P 500 companies have taken the first steps, and internal entities responsible for transition risks exist, few have a clear understanding of the risks themselves and the financial implications for their business. One significant material benefit in tackling transition risks is that rating agencies take into consideration these actions in their ESG metrics when evaluating an organization's efforts, which affect borrowing rates and direct costs to the organization.

Beyond the general goal setting and strategies, there are other material components to consider, such as the use of renewable energy, siting considerations for facilities, and climate-related re-evaluation of supply chains. A future use that still requires greater exploration is the transfer pricing implication, especially when an entity is working in multiple jurisdictions with different regulatory requirements. The costs associated with shifting operations from one jurisdiction to another can also include the climate-related costs associated with that entity's internal transactions. As more regulations or market drivers emerge, it can be expected that new opportunities and risks will continue to arise.

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