Firstpost.

How climate change is increasing business solvency risk

As climate change presents a real threat to ecosystems and habitats, it poses a domino threat to survival of businesses as solvency risk gets exacerbated

Medha Shekar December 15, 2021 08:11:30 IST

File image of "1.5 Degrees" in white neon lit on the Eiffel Tower in the French capital, as the COP21 United Nations Climate Change Conference took place at Le Bourget, on the outskirts of Paris, in 2015. AFP

The debate on climate change has become more mainstream over the last couple of years as public awareness, frequent extreme weather events and growing scientific evidence of climate change has come to the fore. The recent COP26 climate summit in Glasgow culminated with renewed climate change pledges by nations and commitment to reducing carbon emissions to limit global temperature rise, striving for climate change justice.

Today, climate change is being evaluated by all agents to understand its implications. Climate change mitigation measures hold relevance not only for the survival of lives but also for livelihoods. As climate change presents a real threat to ecosystems and habitats, it poses a domino threat to the survival of businesses as solvency risk gets exacerbated. The world’s first “climate change bankruptcy” of PG&E in the United States in 2019 is a case in point.

Businesses are vulnerable to climate change effects, especially those that are operating in the energy, transport, agriculture, and forestry sector. On the supply side, natural resources are key inputs for several businesses and their scarcity or degradation can severely affect the production activities of businesses along with increased costs and supply disruptions. At the same time extreme weather events or natural disasters like floods, hurricanes, wildfires, etc., and the resultant damage to property pose a physical risk to the survival of businesses.

In such scenarios, businesses are forced to divert their scarce resources towards the reconstruction or replacement of infrastructure. The shift in climate patterns like sustained increase in temperatures can harm the production activities of some businesses in the long run. Apart from direct value losses and losses of capital assets of the business, there can be other spill-over effects like impact on cost and availability of insurance and reinsurance to businesses due to increasing solvency risk to insurance companies themselves due to climate change impact on their assets and changing claims patterns.

Some companies such as oil conglomerates are now facing high litigation costs as an increasing number of legal cases are being filed against them, holding them liable for losses related to environmental damage that may have been caused by their actions or omissions.

The aforementioned factors can accentuate the underlying financial stress of firms, leading to solvency problems. Climate change has become an important factor in the decision-making process of firms. In the event a company enters the insolvency resolution process, going forward, climate change will affect its insolvency resolution prospects.

For instance, a resolution applicant's assessment of the turnaround potential of a firm would include the current carbon footprint of the firm and potential for technological innovation and deployment of energy-efficient processes to reduce the same. Climate change could also affect the valuation of assets of the insolvent firm. The reputational damage caused by climate change-induced insolvency could also adversely affect the going concern value of the business.

Institutional investors of today prefer to quantify their exposure to assets that are carbon linked in their investment portfolios. Going forward banks may also shift lending away from carbon-intensive businesses to greener businesses. Insolvency professionals handling climate change-induced insolvencies will have to ensure effective corporate governance including climate change disclosures, arrange for interim finance and manage several types of claims arising from acute events or chronic climate impacts.

Insolvency of larger businesses could have a domino effect leading to small business insolvencies. The courts adjudicating on insolvency matters would also have to bear in mind the evolving public policies and regulatory frameworks in response to climate change while approving the resolution or liquidation of a company.

There is also the risk of feedback loops developing between the effects of climate change on the real economy and those on financial markets. Banks, insurance companies and asset management firms are high impact sectors in this regard.

According to the Financial Stability Board (FSB), increased physical risks associated with climate change could result in both market and credit risks to the financial system, reducing the value of investments, and increasing risks to lenders and other financial market participants. Further, this may alter the behaviour of financial institutions such that banks may reduce lending and insurers may reduce insurance coverage, leading to an overall reduction in their support to the real economy.

The transition from carbon-intensive production to a low carbon one with the support of new technologies is the way forward for businesses for their survival in the long run. As former Bank of England's Governor Mark Carney had once remarked that those businesses that fail to adapt to climate change, "including companies in the financial system, will go bankrupt without question, and yet there are great fortunes to be made" if low-carbon intensive measures are adopted by businesses.

Both mitigation and adaptation strategies will help businesses in tackling climate change-induced risk to solvency. As per the Intergovernmental Panel on Climate Change (IPCC), mitigation measures would entail the use of new technologies, clean energy sources, reduced deforestation, improved sustainable production methods, and changes in behaviour and adaptation would include effective management of climate change risks by reducing vulnerability and exposure to its harmful effects and developing any potential upsides.

Businesses will need to adopt these measures if they wish to manage their insolvency risk due to the unavailability of adequate capital investment for investing in 'climate friendly' practices. Access to capital will be a potential challenge for businesses as financial institutions like banks, insurers will make climate-sensitive investment decisions.

A host of financial products would need to be developed to fund the transition to low carbon production and finance climate resilience. Companies will have to make climate-related disclosures going forward, irrespective of whether they follow FSB's Task Force on Climate Related Financial Disclosures ("TCFD") recommendations regarding climate disclosure and governance. Similarly, strategic planning by companies would include scenario planning to provide for various climate change scenarios having an impact on profitability.

Adoption of these measures would entail transition risks that are risks associated with the policy, legal, technological, reputational, and market changes in response to climate change. Various ratings agencies, data companies, and actuaries would also need to develop a new set of metrics to measure the resilience of companies to climate change risks for the benefit of financial institutions and investors.

While climate change poses significant challenges for businesses going forward, not all is lost as the latter also presents opportunities to make businesses more competitive and unravel new market opportunities. For instance, to be energy efficient, businesses can optimise resource productivity, thereby reducing operating costs. Climate change can nudge businesses to innovate new products and services that are less carbon-intensive and develop an edge in their sector.

PG&E might be the first and only recorded climate change bankruptcy till now, but it is certainly not the last one. Unless measures are taken quickly by businesses to factor in climate change disclosures and preparedness in their business strategy, the impact of climate change may be sudden and difficult to recover from quickly, leading to solvency problems. Climate change action is the need of the hour to save both lives and livelihoods, the ecology, and the economy.

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