WHY BOARDS NEED TO REVISIT THEIR RISK MANAGEMENT POLICIES

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When it comes to Board matters, the agenda is the most carefully curated piece of document. Not only it has legal significance but it is the roadmap to the operations of the Company. However, most of the time the board agenda is the culmination of what the committees perceive to be important, which is in a way also the justification for having specialised committees. One agenda item which can impact the CSR, Risk Management Committee, and the Board is climate risk. The interrelation is simple, the Risk Management Committee will isolate the risk factors, then the CSR committee will take up projects to mitigate the risk, and the Board will analyse the outcome and report to Stakeholders.

So, it will be of great help if we can analyse a standard definition of climate/nature-related risk. We can take the definition of nature as given by the Taskforce on Nature-related Financial Disclosures (TNFD) , which means "The natural world, with an emphasis on the diversity of living organisms (including people) and their interactions among themselves and with their environment. On taking a closer look, we tend to appreciate three facts:

a) The emphasis is on diversity, which will vary between various geographies;
b) Nature is mostly about the interaction between living organisms which includes humans;
c) Lastly, nature involves the interaction of living things with the environment.

Now coming to what can be a Natural risk, TNFD defines it as, "Potential threats posed to an organisation linked to their and wider society's dependencies on nature and nature impacts. These can derive from physical, transition and systemic risks". The definition speaks of two important concepts, dependencies and nature impacts. Dependencies, primarily mean such risks arising from the absence of any material factor which makes the production process no longer viable. For example, industries like breweries and carbonated beverage water; dairy industries; sugar mills and refineries; textile manufacturing; pulp and paper mills and even mining etc. have to depend on water. Now all these activities will become inoperative if they are no longer able to access water from natural sources and have to depend on transported water.

To put things in a wider perspective, climate risks include storms, flooding, droughts, wildfires, and extreme heat conditions that cause direct damage to the physical capital stock. Indirectly, they can reduce labour productivity. Similarly, valuable resources may be diverted to rebuild, infrastructure that may have been lost to climate forces. As production is disrupted, debt costs become unserviceable, and a vital source of livelihood may be lost which triggers migration. If the impact of these factors is quantified in some economic indicators, then for India, as per the G20 Climate Risk Atlas,

economic impacts on sectors like agriculture, fisheries, infrastructure, tourism and more could cause a massive loss of 5.21% of its GDP by 2050. That rises to 9.9% by 2100.

This makes it imperative for corporations to invest heavily in remedial measures. The regulatory framework of the Companies Act, 2023 does mandate formulating a risk management policy whereby the Board and Independent Directors are responsible for it. Similarly, the SEBI (LODR) 2015 gives limited guidance on the functions of the Risk Management Committee, by mentioning some functions in its Schedule. The current BRSR reporting norms mention how risk arising from climate change can include impact on operations, worker health, demand for products or services etc. Climate change opportunities can include cost savings through resource efficiency, development of new products and services, access to new markets etc. It also mentions the rationale for identifying the risk, which may include a description of the impact associated with the risk or opportunity, Extended producer liability and Waste management. However, given the magnitude of climate risks, more granular guidance is required to build a robust policy commensurate to the industry or size of the entity. A general approach for dealing with all business risks including climatic risks undermines its impact and often catches the company unprepared.

The relevance of having a customised risk mitigation measure for climate risk was felt by the Reserve Bank of India, which proposed that banks should look at integrating climate and environmental risk in their risk management framework consistently and systematically. Such policy should clearly define the roles and responsibilities of business lines and risk functions by the three lines of defence model. The first line of defence is provided by business line staff, who may assess climate and environmental risk before accepting new business and throughout the ongoing management of business relationships, particularly for sectors with higher climate-related and environmental risk. The second line of defence is provided by the risk management function that may monitor the implementation of the bank's climate risk management policies by business lines. The third line of defence is provided by the internal audit function that may conduct independent reviews and evaluate the robustness of the bank's risk management framework in managing climate-related and environmental risks. A range of quantitative/qualitative metrics and tools may be used to monitor the exposure to financial risks arising from climate change, proportionate to the entity's size, business activities and complexity of business operations. In determining the climate-related and environmental risk metrics, the materiality of the climate-related and environmental risk factors, and risks of greater materiality may be prioritised and monitored more closely.

However, other business entities need to take an urgent look at their risk policies to make them more objective in dealing with climate risks. Hence we can look at some parameters specific to dealing with such risk that can make the Risk policy more appropriate.

- Consideration of short and long-term factors for climate risks;
- Disclosure to stakeholders in a transparent manner of climate risks determined by it;
- Role and responsibility of heads of businesses, Chief Risk Officer (CRO), Chief Financial Officer or Chief Sustainability Officer or a combination of them;
- Extend the scope of the Existing risk management committee and define clear terms on sustainability or environmental risk management;
- Clear escalation policy for initiating action on climate risks;
- Quarterly materiality assessments and scenario analysis under various outcomes and time horizons;
- Half-yearly updating of existing frameworks and policies to incorporate environmental risk considerations;
- Scrutiny of Responsible Business Conduct and adherence by other parties to global standards like the UN Global Compact, OECD Guidelines etc. before entering into business contracts ;
- Exclusion criteria for certain activities or contracts with companies with more specified exposure;
- Specific approach for Small and medium-sized enterprises (SMEs) which tend to have less capacity and fewer resources at their disposal to manage and disclose their environmental risk ;
- Integrating sustainability considerations into investment decisions;
- Internal sensitisation and training to raise awareness and encourage better management and mitigation of the identified risks and
- Approval of disclosures for ESG reporting by the Risk Management Committee.

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