Climate Change Governance: What Shareholders and bondholders can do?

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Managing climate change risk will be the key to sustainable value creation for businesses

The risks related to climate change are the four out of the top five risks the World is facing today– in terms of impact and likelihood (WEF, 2020). The risk is already recognized as a material risk to the financial system. This risk can affect the financial performance of corporates severely in the coming decades, if not controlled, particularly to the corporates whose businesses are GHG-emitting and polluting. The impact has started affecting firms for the last couple of years, but its severity will be felt in the medium to long-term. Although climate change risk is sure to be materialized, its outcome and timing are uncertain as there is limited historical information on this risk. As the future is uncertain and evaluating economic benefits is challenging, controlling future risks will help the business survive during a slump and prosper during a surge. So, this boils down to making the right business decision that allows firms to live longer and thereby generate a sustainable economic return over the long-term. There is enough evidence that suggests that corporates who identify, measure, control, and manage this risk are more likely to mitigate this imminent material risk; a proper risk management system can also improve their return on investment. The bondholders should be more concerned about this risk since they always want to protect the downside risk. It is notable here that climate change risk is a more significant worry for medium to long-duration bondholders as this risk is likely to materialize over the medium to long term.

Short-term perspectives expose the equity and bondholders to long term risk

In modern business enterprises, most of the critical business decision-making is in the hands of the managers (agents), who are hired by shareholders (principals) to perform activities for the best interests of principals. However, a contract between principal and agent is not giving significant incentives for agents to make the business sustainable and value creative over the long term (Bolton, 2015). The existing incentive structure exerts pressure on agents to increase short earnings of the company while neglecting the sustainable value creation of the company. A large chunk of the manager's compensation in the form of a bonus is tied to short-term profitability and stock price of the firm (Velenti, 2013). This short-sighted compensation structure encourages managers to save money in the short term, even if it is emission carbon, polluting the environment, or not taking any step to mitigate the climate change risk. However, this short-termism may improve the profitability of the firm in the short-term but expose the firm to unsystematic climate change risk. The financial market is

also exerting pressure on management to make decisions, which increases the stock price as quickly as possible without considering the long-term impact of their business decision making. The financial market's reaction to climate change risks is inadequate, particularly in developing countries due to friction in the market. Hence, the management of the company is not taking adequate measures to mitigate climate change risk. Since the time-length of top management in the same company is getting shorter, there are not enough incentives for the management to make business decisions that can bring long-term benefits. This kind of precarious situation warrants investors to take measures that can make the company climate-resilient. It is different for bondholders as they do not have any control over the management.

Aligning compensation structure with the climate-change risk mitigation plans

A right compensation structure that encourages long-term performance and better risk management can enable the firm to mitigate this risk and create sustainable value. The compensation structure must align the interests of management and long-term investors. Besides salary and stock options, the board can add climate change aspects in the compensation plan. The board can set a long-term target of reducing GHG emissions per unit of revenue by a certain percentage from the base year with an annual target. If GHG emission increases more than the target in any year, the stock option issued to the management will not be triggered even if the management meets all other criteria for getting a bonus. The board can appoint a third-party agency, directly reporting to the board, verify GHG emissions target. The third-party agency can also report on the company's climate risk mitigation plan as well.

Additionally, the board can design the compensation contract with the management to make sure that sustainability/climate change (climate change) rating would not decrease in the future. There are third-party rating agencies such as Morning Star, CDP, which rates companies based on climate change. The sustainability or climate change rating depends on the management's commitment and strategy, unlike credit rating, which could not be in the management's control, such as the impact of the macroeconomic performance on credit rating; hence, management would agree with this performance parameter. When the company's climate change rating is too low or below the industry average, the board can set a medium-term target for the management to improve the climate change rating and links the variable compensation with improvement in climate-change rating. These measures will force the management to make decisions by incorporating climate change risk.

Designing bond covenants keeping climate change risk in mind

It is ideal the bondholders engage with corporates proactively and effectively in the governance process of climate change since they are also stakeholders of the company. In reality, the Corporates

do not engage bondholders in business decision-making, strategic planning, and governance. However, there are specific ways the bondholders can play an active role in the corporate's risk management strategy concerning climate change. The bondholder can incorporate certain covenants related to climate risk in the bond contract. The positive covenants could include maintaining minimum climate change rating, reduction of GHG emission over a period, and maximum GHG emission per unit of debt. The negative covenants could be the prohibition of acquisition of or investment in a GHG-intensive and polluting business and avoiding climate litigation. Besides, the bondholders can also add a condition that the proceeds of additional debt cannot be used for GHG-intensive businesses. The bondholder can also add a poison put option to the bond contract, which will allow bondholders to sell their bonds to the company at a premium if GHG emission per unit of debt is not reduced (targeted earlier) or cross a specific limit. For floating rate bonds, the interest rate can also be linked with GHG leverage or climate change rating. An increase in GHG leverage (let us call it EBITDA/GHG emission) or deterioration of climate change rating would increase the interest rate of the bond. Like cross-default provision, the bondholder can add covenant such as cross – climate-change rating downgrade; if there is any climate change rating downgrade of other bonds of the issuer, that will trigger the acceleration of payment to the bondholders. A fall in climate change rating of other bonds is a signal that the corporate is not properly managing its climate change risk. These covenants will protect bondholders against climate change risk if the corporate does not make the right decisions to implement climate risk mitigation plans.

Reference

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