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On March 21, 2022, the Securities and Exchange Commission (SEC) proposed new rules that would require publicly traded companies to disclose their climate-related financial risks. The press release and the links to the related publications are available from the SEC page. In this issue of the CAFIN bulletin, we briefly discuss the reason for this proposal, the costs and benefits of proposed disclosures, and what implementation of these rules will mean for the investors.

SEC Proposed Rules to Enhance and Standardize Climate-Related Disclosures

Every company faces climate-related risks. These risks come in two main forms: physical risks and transition risks. Physical risks can be acute, or those arising from climate-related extreme weather events, such as increased frequency of fires, floods, hurricanes, or chronic, such as those related to rising temperatures and sea level. Physical risks are likely to affect physical capital through potential property destruction as well as revenues through business interruption and productivity losses, especially in agriculture. Transition risks are risks that arise from actions taken by governments, investors, or consumers, or from technological innovations that are designed to mitigate climate change but may lead to making certain equipment, processes, and assets obsolete.

Disclosure of climate-related risks is becoming common but lacks reliability and uniformity. In recent years many countries made steps toward harmonizing climate risk disclosures. The requirements took effect this year in the UK, they remain mandatory in the EU, and Canada has announced plans for their own requirements. Many companies around the world are voluntarily disclosing their exposure to climate risks through Task Force on Climate-Related Financial Disclosures (TCFD), or their membership in Principles of Responsible Investment (PRI) or Principles of Responsible Banking (PRB) initiatives. Proposed SEC rules are based on TCFD methodologies and therefore would impose little additional disclosure burden on companies that already disclose their risks.

Disclosure requirements have important benefits when compared to voluntary disclosures. There are two main concerns with TCFD disclosures - lack of comparability across institutions, and lack of auditing. Introducing detailed rules will help investors through uniformity of reporting, easy access to disclosures, and assurance of the reliability of said disclosures because of the required audit. Moreover, given increasing investors' concern about climate-related risks, companies that are currently not disclosing their climate-related risks might be subject to adverse selection, arising from investors' assumption that they might have something to hide. If such companies have lower climate-related risks than investors are expecting, they might benefit from such disclosures.

Required disclosures are likely to enhance risk management and lead to the reduction of transition risks. Any new regulation always raises concerns about additional regulatory burden on companies. However, climate-related financial risks are real, as was recently illustrated by the bankruptcy of PG&E due to the higher frequency of large wildfires in California. Any company needs to be evaluating its exposures to such risks as a part of its best practices in risk management. In this sense, detailed disclosure rules provide the blueprint for measuring such risks and will also likely lower the cost of obtaining professional services in evaluating such risks. Moreover, disclosure of future risks will lead to the incorporation of these risks into asset prices, therefore reducing the probability of a large sudden asset repricing and related financial stability problems, should important climate mitigation measures take effect.

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