Beyond ESG:
Why the SEC is right to make climate risk disclosure mandatory

The regulator has provided a blast of fresh air to revitalise capital allocation

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With the increasing frequency and severity of extreme weather events comes a heightened focus on the risks of climate change. But in the absence of consistent financial reporting on them, investors and companies have had to hazard their own guess of the impact on markets and the economy.

The reason for this is simple: there are no required standards for climate risk reporting. This changed last week when the regulator of the world's largest capital market, the Securities and Exchange Commission, voted to issue proposals for mandatory climate risk reporting by public companies.

The International Energy Agency estimates that to achieve net zero emissions by 2050, global investment in the energy sector alone will need to grow to about $5tn a year in less than a decade.[1] Given huge public-sector indebtedness, the bulk of the required capital will need to come from the private sector.

One barrier to deploying that vital private capital is the lack of investment-grade data that allow investors to make sound investment decisions. Currently, climate data disclosure ranges from voluntary in the US to mandatory in France to a comply-or-explain approach in Australia. And there is a wide variation in voluntary standards inspired by the Taskforce on Climate-Related Financial Disclosure, commissioned by the G20.

To direct private capital to address the complex and daunting challenges of the energy transition, climate risk disclosure needs to be standardised, mandatory and regulated in the same way as financial reporting to ensure it is timely, accurate, complete and verified.

At first blush, companies may resist the SEC's call for new reporting that investors need, arguing that climate data are not readily available and disclosing them is cumbersome and costly. Given the lack of standardisation, disclosing such undefined data may also expose a company to litigation risk. Although these are valid points when viewed in isolation, companies will benefit financially in two ways: in revenue gains and a reduced cost of capital.

A recent study by FCLT Global and Wharton put numbers to this proposition. Companies demonstrating that they were "walking the talk" on sustainability saw improved sales and return on invested capital. Data from MSCI also shows companies that ranked high on sustainable practices won a lower cost of capital.[2]

One elegant explanation for this comes from Professor George Akerlof's theories on the market impact of information asymmetry.[3] A classic example is when borrowers hold more information about a project than potential lenders. As such, lenders will demand a higher financing rate, more collateral or just outright reject the request.

Borrowers pay higher financing costs while lenders lose out on good opportunities. Standardised and mandatory financial disclosure mitigates such adverse effects. The same arguments apply to the disclosure of climate risks. If companies choose not to disclose, investors will assume the worst and charge more for capital.

The SEC has drafted its proposals with care. It proposes a safe harbour provision that provides protection from legal liability on certain elements, such as reporting "scope 3 emissions", the greenhouse gases generated through company supply chains. To calm nerves further, the SEC proposes to introduce the requirements in stages and to give small companies respite. And the running theme across the proposals is materiality: they require only information that a reasonable investor would expect to find useful.

Investors will note that the SEC calls for disclosure on other vital issues, such as carbon pricing or targets for emission reductions. However, a caveat that may unsettle some is that these points of disclosure will only be required where such measures have been adopted by companies. The rising number of shareowner proposals, though, shows clearly that investors will buttress the SEC's requirements by ensuring companies do not avoid action on carbon pricing and targets.

The SEC's example is soon to be followed by the International Financial Reporting Standards own initiative to build climate risk reporting standards, through its newly formed International Sustainability Standards Board. This will roll out its proposals for consideration by regulators in 144 markets worldwide.

If information is the oxygen of financial markets, then the SEC has just provided a welcome blast of fresh air that can revitalise capital allocation for the benefit of all.

Endnotes

1. Source: International Energy Agency, "Net Zero by 2050" last updated May 2021.
2. Source: MSCI, "ESG and the cost of capital," 25 February 2020.
3. American Economist George Arthur Akerlof is a university professor at the Georgetown University and the University of California, Berkeley. In 2001 he was awarded the Nobel Memorial Prize in Economic Sciences jointly with Michael Spence and Joseph Stiglitz.

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