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Floods, Fires and Financial Markets – The Emerging Lexicon of Climate Change Risks

On September 9, 2020, the Commodity Futures Trading Commission's (**CFTC**) Climate-Related Market Risk Subcommittee of the Market Risk Advisory Committee (**MRAC**) released a report entitled 'Managing Climate Risk in the U.S. Financial System'.

The report presents 53 recommendations to mitigate the risks to financial markets posed by climate change. In reaching those recommendations, the report issues a series of fundamental conclusions about the impact of climate change on economic and financial markets and the increasing likelihood of severe and unpredictable change.

In particular, the MRAC confirmed that: (i) climate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy; (ii) climate risks may also exacerbate financial system vulnerability that have little to do with climate change; including vulnerabilities caused by a pandemic that has stressed balance sheets, strained government budgets, and depleted household wealth; and (iii) U.S. financial regulators must recognize that climate change poses serious emerging risks to the U.S. financial system, and they should move urgently and decisively to measure, understand, and address these risks.

Notably, the report observed that "regulators should also be concerned about the risk of climate-related 'sub-systemic' shocks," which are events "that affect financial markets or institutions in a particular sector, asset class, or region of the country, but without threatening the stability of the financial system as a whole."

This acceleration of climate-related risk exposure comes against the backdrop of growing demand from investors, shareholders, consumers, and some governments for more – and more detailed – public disclosure. This growing demand is being driven by a broad range of inter-related factors, including among others:

- a solidifying (and perhaps nearly solidified) international consensus that climate change is real;
- increased recognition that climate change and other environmental, social and governance (**ESG**) costs and risks can materially impact business earnings and prospects;
- an evolving global consensus that **ESG** costs and risks (including but not limited to climate and carbon) should be accounted for and disclosed both to investors and to the public more widely;
- increasing shareholder activism focused on climate and ESG.

If there were any doubt about the direction these issues are taking, it should be erased by Blackstone CEO Larry Fink's January 2020 annual CEO letter,[1] in which Fink argued that climate and sustainability must be corporate – and financial investment – priorities. Asserting that "[c]limate change has become the defining factor in companies' long-term prospects," Fink announced that Blackrock would take a number of steps to make "sustainability… our new standard for investing."

Among other things, Fink pledged to: (i) make "sustainable funds" the standard building blocks of its investment strategies; (ii) ensure that every Blackrock investment team integrates ESG reviews in its investment processes; (iii) reduce ESG risk in its active investments by substantially reducing coal investments; (iv) focus investment on solutions that support the transition to a low-carbon economy; and (v) develop and promote metrics to measure and compare companies' climate / ESG risk profiles, which will be fundamental to all investors' ability to accurately price risk and assets around the world.

Following Blackstone's lead – or mirroring his approach – a broad range of global corporations and financial institutions have made similar announcements about their own commitment to sustainability and addressing climate, including Microsoft, Amazon, Delta, Google, Goldman Sachs, and many others.

While market and investor demands appear to be playing the driving role in influencing ESG behavior, governments may be beginning to catch up. As part of the European Commission's "European Green Deal," in January 2020 the Commission launched a preliminary consultation on alternative approaches for revising the Non-Financial Reporting Directive (Directive 2014/95/EU) (**NFRD**).[2]

Active discussions are ongoing, and, while they are very preliminary, it is widely expected that some new reporting requirements will be implemented. Such new requirements are likely to have a ripple effect in other parts of the world, including the United States.

U.S. disclosure guidance on climate is governed principally by Regulation S-K and limited guidance issued by the U.S. Securities and Exchange Commission (**SEC**) in 2010 (the "2010 Climate Disclosure Guidance")[3]. SEC rules generally require public companies to disclose, among other things, known trends, events and uncertainties that are reasonably likely to have material effect on the company's financial condition or operating performance through annual or other periodic filings. Regulation S-K contains disclosure requirements that are applicable to the non-financial statement portion of periodic filings.

The SEC published the 2010 Climate Disclosure Guidance to provide guidance to companies on how existing requirements apply for climate-related matters.

The 2010 Climate Disclosure Guidance identifies four items in Regulation S-K that might require climate-related disclosure in periodic filings:

- **Description of business** – Item 101 of Regulation S-K requires a registrant to describe its business and that of its subsidiaries. In particular, a registrant ordinarily must disclose any material effects that environmental matters may have on the financial condition of the registrant. The registrant is required to disclose two particular pieces of information regarding environmental matters: (i) the material effect of complying with federal, state, and local regulations concerning the environment; and (ii) any material estimated capital expenditures for environmental control facilities.
- **Legal proceedings** – Item 103 of Regulation S-K requires a registrant to briefly describe any material legal proceeding to which it or any of its subsidiaries is a party. This includes proceedings "known to be contemplated" by governmental authorities.
- **Risk factors** – Item 503(c) of Regulation S-K requires a registrant to provide where appropriate, under the heading "Risk Factors," a discussion of the most significant factors which make an investment in the registrant speculative or risky. Item 503(c) specifies that risk factor disclosure should clearly state the risk and specify how the particular risk affects the particular registrant.
- **Management's discussion and analysis** – Item 303 of Regulation S-K requires disclosure known as the Management's Discussion and Analysis of Financial Condition and Results of Operation, or MD&A. Item 303 includes a broad range of disclosure items that address the registrant's liquidity, capital resources and results of operations. Registrants, for example, must identify and disclose known trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance. This disclosure should highlight issues that are reasonably likely to cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition.

The 2010 Guidance also identified four different topics under which climate-related risks can be categorized and for which disclosure may be required under the federal securities laws. Those topics are: (i) impact of legislation and regulation; (ii) international accords; (iii) indirect consequences of regulation or business trends; and (iv) physical impacts of climate change.

The SEC has not updated its 2010 Climate Disclosure Guidance, and the agency's most recent proposals in January 2020 to modernize Regulation S-K and Regulation S-X did not address climate-related risks. Similarly, revisions to the EU's NFRD will take some time to develop and come into force. Still, U.S. companies and financial institutions could face regulatory scrutiny on climate-related matters from a number of regulatory agencies.

In late 2019, two senior U.S. Federal Reserve Board officials made notable public statements about potential climate change impacts on the U.S. economy. Kevin Stiroh, an executive vice president of the Federal Reserve Bank of New York, declared that "[t]he U.S. economy has experienced more than $500 billion in direct losses over the last five years due to climate and weather-related events."[4]

He added: "Climate change has significant consequences for the U.S. economy and financial sector through slowing productivity growth, asset revaluations and sectoral reallocations of business activity."[5]

Stiroh reinforced these comments in March 2020, when he cautioned that "financial markets and institutions face the potential for a 'Minsky moment' related to change climate – an abrupt repricing of assets in response to a catastrophic event or change in investor perceptions."[6]

Stiroh's concerns were echoed by Federal Reserve Governor Lael Brainard, who said: "To the extent that climate change and the associated policy responses affect productivity and long-run economic growth, there may be implications for the long-run neutral level of the real interest rate, which is a key consideration in monetary policy."[7]

Brainard noted that based on climate-related financial exposures reported to the Carbon Disclosure Project, estimates are that "the 500 largest companies by market capitalization are exposed to nearly USD 1 Trillion in risk, half of which is expected to materialize in the next five years."[8]

Similarly, as part of its report, the MRAC recommended that The Financial Stability Oversight Council (**FSOC**), as part of its mandate to monitor and identify emerging threats to financial stability, should incorporate climate-related financial risks into its existing oversight function, including its annual reports and other reporting to Congress.

Under the current working framework, the regulators serving on the FSOC have established a list of roughly six criteria to be applied when evaluating whether a financial activity "could amplify potential risks to U.S. financial stability."

As the Federal Reserve and other U.S. financial market regulators begin to assess the risks of climate change, the larger question remains as to how those agencies will integrate those risks into their regulatory and supervisory frameworks. With investors paying increased attention to climate-related risks and as most firms lack detailed quantitative disclosures, it is critical that companies (including in particular but not only publicly-listed companies) develop internal processes for identifying climate and other ESG risks and assessing their potential impact on their financial condition.

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[2]See https://ec.europa.eu/info/strategy/priorities-2019-2024/european-green-deal_en and https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en.

[3]17 C.F.R. § 229.101 et seq.; Securities and Exchange Commission, Commission Guidance Regarding Disclosure Related to Climate Change, 75 Fed. Reg. 6290 (Sept. 8, 2010).

[4]Kevin J. Stroh, Executive Vice President, Federal Reserve Bank of New York, Emerging Issues For Risk Managers, Introductory Remarks at the GARP Global Risk Forum (Nov. 7, 2019).

[5]Id.

[6]Kevin J. Stroh, Executive Vice President, Federal Reserve Bank of New York, Climate Change and Risk Management in Bank Supervision (March 4, 2020).

[7]Lael Brainard, Governor, Federal Reserve Board, Why Climate Change Matters for Monetary Policy and Financial Stability (Nov. 8, 2019).

[8]Id.

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