The Daily Dish

Disclosing Climate Risks

DOUGLAS HOLTZ-EAKIN | MARCH 1, 2021

Eakinomics: Disclosing Climate Risks

The Hill paper has a nice report on the efforts by financial regulators to establish a regime for disclosing climate risks: "After years of pressure from environmentalists and advocates for tighter financial rules, leaders at the Federal Reserve, Securities and Exchange Commission (SEC) and Treasury Department are laying out how the companies they regulate will be expected to respond to the climate-related risks facing the financial sector." This is an important development, but don't expect this to be quick or easy task.

At a conceptual level, the first step is not simply to acknowledge risks, but to measure them in a consistent fashion over time, across space, and between firms. Since the future path of climate change is uncertain, this requires a scenario, or scenarios, that are standardized so that all firms are evaluating the same circumstances.

The next step is to translate each scenario into its implications for markets and technologies, physical risks, and reputational risks. For example, the scenario may include sea-level rise. That rise might threaten physical facilities of a financial firm, thereby affecting the value of assets on the balance sheet. It might also threaten the firms' financial assets, ranging from mortgages that would be impaired to equity investments in businesses located in the endangered geography.

Notice that if the financial firm discloses greater such risks than its competitors, it will be valued less. That is an incentive to shift away from lending or investing to those in the risky geography and shifting capital to (climate) safer areas. The flip side of these decisions is reduced access to capital, and reduced economic activity, in the areas most exposed to the sea-level rise. In this way, disclosure can enhance adaptation to climate change because financial incentives direct the economy to climate-safer areas and activities.

The next – and harder – step would be to disclose not only risks from climate change but also risks imposed by policies to address climate change. Again, since the future path of U.S. climate change is not known, much less the policies across the globe, this will require some scenarios. But the act of constructing those scenarios will likely become a political football. Does a government regulator want to risk including, e.g., a carbon tax of $50 per ton in 2036? Or any other amount at some other date, even in the context of a *potential* future scenario firms might face?

Disclosure of climate risks can be valuable information about financial firms, and can support the adaptation to minimize the impact of climate on the economy. But it is an enormous task fraught with difficulty.