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SEC Commissioner Lee: SEC Must Address Systemic Financial Risk Posed by Climate Change - Cooley

At last week's PLI annual securities regulation institute, SEC Commissioner Allison Lee gave the keynote address, *Playing the Long Game: The Intersection of Climate Change Risk and Financial Regulation*. She began her remarks with the pandemic as metaphor: a global crisis that, before it struck, was "understood intellectually to be a serious risk," but not fully appreciated as something we really needed to worry about. Now, we have experience of a crisis, no longer viewed "antiseptically through our TVs or phones, but firsthand as it unfolds in our homes, families, schools, and workplaces—not to mention in our economy. Seemingly theoretical risks have become very real." Another dramatic risk that looms even larger with potential for more dire consequences is the topic of Lee's remarks: climate change. According to a 2018 study by scientists in the U.K. and the Netherlands, the "point of no return" for achieving the goal of two degrees Celsius by 2100 set by the Paris Accord may arrive as soon as 2035. To be sure, the lesson from the pandemic is "not to wait in the face of a known threat. We should not wait for climate change to make its way from scientific journals, economic models, and news coverage of climate events directly into our daily lives, and those of our children and theirs. We can come together now to focus on solutions." And while this is hardly Lee's first rodeo when it comes to advocating that the SEC mandate climate risk disclosure, it seems much more likely now, with the imminent change in the administration in D.C., that the SEC may actually take steps toward implementing a regulatory solution.

Acknowledging that the SEC does not make policy to address climate change, Lee highlights the role the SEC does play—protecting investors, facilitating capital formation and maintaining fair, orderly and efficient markets—and how they all intersect with climate change. At a high level, financial regulators, including the SEC, must understand and, "where appropriate, address systemic risks to our economy posed by climate change. To assess systemic risk, we need complete, accurate, and reliable information about those risks. That starts with public company disclosure and financial firm reporting, and extends into our oversight of various fiduciaries and others. Investors also need this information so they can protect their investments and drive capital toward meeting their goals of a sustainable economy."

According to Lee, there is a "growing consensus that climate change may present a systemic risk to financial markets," a view shared by, for example, the Task Force on Climate-Related Financial Disclosure (TCFD) (see this PubCo post), and the Market Risk Advisory Committee to the Commodity Futures Trading Commission (see this PubCo post), among others. (Lee views "systemic risk" as risk "characterized by the following features: (1) 'shock amplification' or the notion that a given shock to the financial system may be magnified by certain forces and propagate widely throughout; (2) that propagation causes an impairment to all or major parts of the financial system; and (3) that impairment in turn causes spillover affects to the real economy.") To the extent that asset prices fail to fully incorporate risks, systemic shock becomes more likely; there is clearly evidence, in her view, that climate risks have not been priced in, especially for "long-dated assets, utilities, commercial mortgage-backed securities, and potentially municipal bonds, among others." In the event of major climate-related events, markets may discover these anomalies, leading to "abrupt and disruptive re-pricing." For example, some have highlighted the "risks of extreme weather events to the creditworthiness of state and local issuers in the municipal bond market, risks of hurricane and flooding to the commercial real estate market, and risks of aging infrastructure in conjunction with hurricanes and wildfires to the electric utility sector."

But these disruptions will not necessarily be cabined within those sectors; rather they can spread throughout the financial system in expected and unexpected ways. The Bank for International Settlements, she observes, has identified climate risk as a "green swan" event—"a colossal and potentially irreversible risk of staggering complexity." Climate risk differs from the better-known "black swan" in the level of its complexity—"a new type of systemic risk that involves interacting, nonlinear, fundamentally unpredictable, environmental, social, economic and geopolitical dynamics, which are irreversibly transformed by the growing concentration of greenhouse gases in the atmosphere."

These disruptive effects compound each other, potentially affecting non-climate related vulnerabilities, such as "historically high levels of corporate leverage, and the effects of the COVID-19 pandemic which has depleted household wealth and bank balance sheets, and created more debt. Climate related shocks could further magnify these vulnerabilities." And these effects may well be irreversible. Because of the potential for a climate-induced "overall shock to the global economy with systemic implications," it is "imperative for the SEC to focus on climate risk as systemic risk, and coordinate with domestic regulators through the Financial Stability Oversight Council, and with international regulators through the Financial Stability Board's Standing Committee on Assessment of Vulnerabilities, to monitor and address this risk."

The starting point, she maintains, must be a "clear-eyed analysis of accurate, reliable data," and there has been an unprecedented demand by investors for climate-related and ESG-related disclosure. Beyond so-called "impact" investing, she observes, climate and other ESG risks and metrics have become significant, decision-making drivers in a variety of sustainable investment strategies, as well as in "traditional investment analyses designed to maximize risk-adjusted returns on investments of all types. They represent a core risk management strategy for portfolio construction.…The bottom line is that businesses now actively compete for capital based on ESG performance, and that competition needs to be open, fair, and transparent."

How do we get there? Through "uniform, consistent, and reliable disclosure." Some disclosure has resulted from private ordering, but, as she has contended previously (see, e.g., this PubCo post, this PubCo post and this PubCo post), "some level of regulatory involvement [is needed] to bring consensus, standardization, comparability, and reliability."

To illustrate, Lee looks to the role of banks, both in financing fossil fuel industries and in the opportunity to finance a shift toward a lower carbon economy, considered by all accounts as "a heavy lift." She advocates that the SEC work with "market participants toward a disclosure regime specifically tailored to ensure that financial institutions produce standardized, comparable, and reliable disclosure of their exposure to climate risks, including not just direct, but also indirect, greenhouse gas emissions associated with the financing they provide, referred to as Scope 3 emissions. There is a concentration of risk in the financial sector that is not readily ascertainable except through Scope 3 emission disclosures." With appropriate resources, the SEC should take on the challenge of implementing appropriate regulatory action as it relates to standardized disclosure requirements.

The SEC must also address climate risk in the context of oversight of funds and their advisers, credit rating agencies and accounting standards. Clear disclosure is also necessary, in Lee's view, in connection with funds marketed as "green" or "sustainable." What does the fund mean by these terms and is the fund implementing a strategy that is consistent with that disclosure? Standardized company ESG disclosure would help, she believes. In addition, she suggests that the SEC consider requiring advisers to maintain and implement policies and procedures governing their approach to ESG investment. She also advocates that the SEC encourage increased transparency at credit rating agencies regarding how climate and other ESG factors are weighted when incorporated into credit ratings.

Lee also asks whether the FASB should look at climate risk in the application of GAAP as the IASB has done in issuing guidance addressing how existing IFRS requirements interact with climate-related risks, and identifying how climate-related risks may need to be reflected in financial statements, including in connection with asset impairments, asset valuations and useful life, contingent liabilities and expected credit losses.

In conclusion, she again alludes to the pandemic as an example of what not to do, advocating that we not wait until the crisis is upon us to respond, but instead “move forward with considered, informed rule-making and other initiatives in this space.”

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