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The Finance Industry Needs Better Climate Disclosures.

Secretary Yellen rightly celebrates the Inflation Reduction Act, John Kostyack says, but the law shines a light on an urgent problem that she and other regulators must address in the financial industry—undisclosed climate risk.

Treasury Secretary Janet Yellen recently celebrated the Inflation Reduction Act's potential to drive down climate-damaging pollution, accelerate technology innovation, and reduce energy costs for businesses and consumers.

The economic opportunities created by this law are indeed worthy of celebration. But as chair of the Financial Stability Oversight Council, Yellen is also obliged to address economic risks associated with these dramatic changes.

Hidden Risks
Last year, the FSOC expressed concerns about the emerging threat of a climate-related financial crisis, including transition risks that arise when businesses and financial institutions aren't prepared to shift to a clean energy economy.

Among the top FSOC recommendations was for a Securities and Exchange Commission mandate that public companies disclose these risks to their investors. A proposed mandate is pending and expected to be finalized this year.

Financial experts fear that lack of attention to hidden climate risk could lead to a "green swan" event, or a sudden and widespread asset deflation that devastates the global economy.

As increasingly ambitious climate laws like the IRA are put in place—and clean energy technologies become increasingly available, affordable, and reliable—greater proportions of fossil fuel reserves become uneconomic, leaving billions in assets valueless and stranded.

Individual savers in the US are uniquely threatened by this poorly disclosed climate risk. A recent study shows they hold $300 billion in high-risk fossil fuel assets, more than individuals in any other country. Even more worrisome, $681 billion of risky fossil fuel assets are on the balance sheets of financial institutions—far more than the subprime housing assets that triggered the 2008 crisis.

Transparency a Given
Expecting public companies to be transparent with their investor-owners is not controversial. In fact, the SEC has been addressing market failures and protecting investors with disclosure rules since the 1930s, with little fanfare.

Thus, the five-alarm response of the fossil fuel industry and its allies to the SEC's climate risk disclosure proposal seems bizarre, perhaps leading a casual observer to believe the SEC, not Congress, limits the industry's greenhouse gas emissions.

Just a month before the IRA's enactment, oil industry leaders filed comments with the SEC vehemently opposing its proposal. Ignoring the enthusiastic support expressed by thousands of investors, the American Petroleum Institute argued that climate risk is not a serious investor concern.

Dismissing concerns about businesses' lack of preparedness for the energy transition, it claimed, despite powerful evidence, that emerging climate laws can safely be ignored until they are implemented.

The Western Energy Alliance's comments on the proposal symbolize the depth of denialism about climate risk in the marketplace and show why the SEC must act now to strengthen its regulations. The WEA falsely claims the SEC is "purposefully suppressing American oil and natural gas production" for the benefit of Russia, which is allegedly conspiring with US climate advocacy groups.

How Disclosures Should Look

In reality, the SEC is not proposing to regulate how or where energy is produced—but instead that public companies' responses to changes in policy, technology, and customer preferences spurred by climate change be disclosed in a useful format for investors.

If there were ever doubts about whether these changes are meaningful enough to warrant investor concern, Congress's enactment of the IRA has dispelled them—along with the launch of similarly ambitious policies this year by California, Australia, the UK, and the European Union. A clean energy revolution is now well underway.

The question facing the SEC is how to provide a disclosure format that enables investors to evaluate companies' preparedness for these changes, and efficiently allocate capital to those that are truly prepared. The most important step will be to require standardized and comprehensive GHG emissions disclosures.

A particular component of these disclosures will be especially important for investors: Scope 3 emissions, or the emissions of customers and suppliers, are a critical measure of transition risk for many companies.

For example, Scope 3 emissions of oil companies and banks include auto emissions. Thus, disclosures would tell investors how exposed these companies are to collapsing demand for gasoline due to the IRA's electric vehicle incentives and EV mandates recently enacted by California.

The good news for investors is that the SEC has demonstrated its understanding of these and other climate risks and has put forward a strong proposal, with only small adjustments needed to strengthen Scope 3 emissions disclosure requirements.

Once the rule is finalized and climate risks are fully disclosed, climate risk-aware investors will be empowered to allocate their dollars to businesses that are taking a thoughtful approach to the twin challenges of decarbonization and resilience to climate change impact.

The SEC has no role in promoting this reallocation of capital. Its statutory mandate is to protect investors by ensuring they receive consistent and reliable information about the risks that threaten the financial condition of public companies.

However, once climate risk information is properly disseminated, the fundamental weaknesses of businesses with no meaningful decarbonization strategies will emerge.

With properly functioning capital markets, investment in well-run, climate-smart businesses will flourish. This will be good news for investors, the stability of our financial system, and the habitability of our planet.

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