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OPINION

Climate Change

# Storms await companies that err on climate

Markets are increasingly willing to punish businesses that mismanage global warming risks

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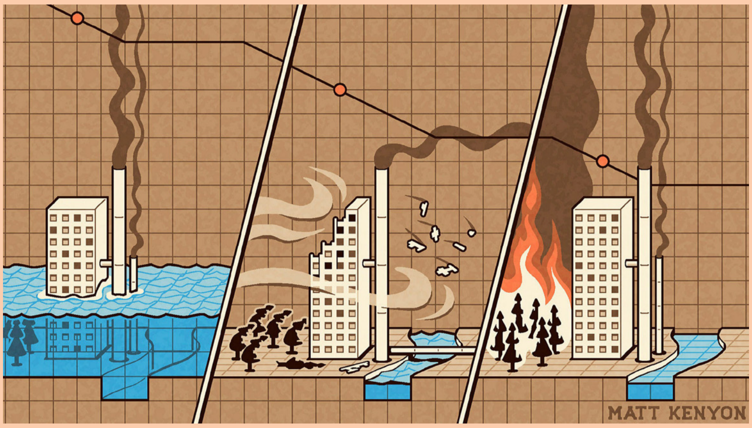


The Atlantic hurricane season, which begins in June and lasts throughout November, is upon us. Coastal homeowners have reason to be worried. So do shareholders.

Until recently, reinsurers and banks have borne most of the market risk of climate change. Now things are changing. Individual companies are being held explicitly responsible for the risks of global warming. A court in The Hague has ordered Royal Dutch Shell to cut its emissions. The International Energy Agency says energy groups must stop new oil and gas projects in order to reach net zero emissions by 2050.

Indeed, market penalties for companies that make bad risk decisions around climate are broader than we might think. A report from Pentland Analytics, "Risk, Reputation and Accountability", looked at several episodes of extreme disaster, including the 2017 hurricane season, which was the most expensive in US history.

Deborah Pretty, the author, examined US-listed companies with annual revenues exceeding $5bn that disclosed financial damage from Hurricanes Harvey, Irma and Maria. Modelling their share price reaction across the year, she found an average 5 per cent discount to the S&P 500 index — the equivalent of $18bn in lost shareholder value.

Pretty also drilled down into companies that had more than 10 per cent of their global insured property values in an affected area, to see what precautions such as flood or wind protection they had taken. Among companies that reported financial damage, fewer than half of recommended measures had been completed. On the other hand, among those that reported no material financial damage, almost two-thirds of the recommendations were completed.

Bottom line? Market perceptions of adverse outcomes from such natural disasters have "changed from bad luck to bad management", says Pretty. Share prices now reflect whether or not the C-suite is taking the risk from climate change seriously. Indeed, Pretty's research shows that the top performing companies are those that consider resilience more important than a balance sheet bargain. In other words, they take every possible action to mitigate such risk, even if the models show that the risk is slight.

This might baffle economists, but as one engineer interviewed in the study put it, "Look, if you have four holes in your boat, and you plug three of them, you're still gonna sink!" It's part of the argument for resilience over economic "efficiency", which is influencing not only preparations for climate related disasters but also supply chains (companies are starting to make them shorter) and cyber risk.

Pretty notes that between 2010 and 2020, poorly prepared companies that came under cyber attack underperformed the market by 20 per cent in the year following the attack.

If regulators have their way, these risks will become more explicit, particularly with regard to climate. G7 leaders last week announced their commitment to mandatory climate-related financial disclosures, modelled on those recommended by the G20's Task Force on Climate-Related Financial Disclosures. This provides a road map for how to integrate climate risk metrics in corporate governance and strategy.

Europe has made more progress than the US in forcing companies to disclose such risk. In Washington, the body best placed to create and enforce such regulation would be the Securities and Exchange Commission. But under President Donald Trump, the SEC loosened regulation generally and failed to mention climate at all. The US government is still subsidising coastal flood insurance, even as cities like Miami explore building multibillion-dollar walls to hold back rising tides.

If the Biden administration has its way, that will change. The SEC, now headed by the ambitious regulator Gary Gensler, just finished gathering public comments on ESG reporting rules. Gensler says he wants to bring "consistency and comparability" to what companies report. That could mean sector specific standards for emissions reporting as well as information on the amount of waterfront property that a company holds, or prevention measures they've taken around flood zones.

Some activists are pushing for extremely granular disclosures around water insecurity, heat stress and the extent to which businesses could be affected by disease, political unrest and migration.

A Center for American Progress report from February, co-authored by Andy Green (now the US Department of Agriculture's senior adviser for fair and competitive markets) lays out the potential range of future reporting requirements.

Should companies be forced to quantify their ESG footprint in ways that make it easy to compare sectors and individual firms' efforts, it's hard to overstate what the market impact could be. The exposure of, say, an apparel maker to agricultural production (and the subsequent potential for crop damage via drought, heat or pestilence) could dramatically affect shareholder value. A price on carbon could change the calculus for some exporters, making activities such as long-distance shipping of heavy machinery much more costly. Asset managers holding too many investments in high-carbon sectors could find themselves in breach of their fiduciary duties.

As hurricane season begins, we might be in for a sea change in markets as well as the weather.

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