Corporate governance

Treat climate change as a systemic risk to global finance

Tools created after the 2008 crisis could empower regulators to act on the environment

TERESA JOHNSON

We are in the midst of a corporate governance pivot from short term stockholder returns towards stakeholder capitalism that values the interests of employees, the environment, customers and the world at large. But we must ensure that environmental, social and governance priorities are built into corporate decision-making in a way that is consistent with the fiduciary duties of directors to protect investors’ interests. And how do we measure progress?

Our experience with restoring financial stability after the 2008 crisis offers salutary lessons that can show us a way forward. Back then, the collapse of Lehman Brothers and the forced rescues of banks all over the developed world made clear how risky the single-minded prioritising of stockholder returns could be for financial services.

My colleague, Chris Dodd, was then in the US Senate and helped lead the American response. He saw that a myopic focus on quarterly earnings announcements had helped push the world’s economy to the brink. Ultimately, it took government intervention through the Dodd-Frank Act, the EU capital requirements regulation and a host of other laws to help reset the rules.

This new regulatory regime made clear that shareholder returns cannot be pursued single-mindedly when the result would jeopardise the stability of the financial system. It allowed governments to work in tandem with financial institutions to restore economic stability and ensure that the sector would be more resilient in the future.

To reach ESG goals, we now need a similar reset that will require companies inside and outside the financial sector to prioritise other issues, such as stopping climate change and improving diversity, alongside shareholder returns. Currently, only shareholders and governments have the power under corporate law to force companies to behave in particular ways. So if a corporation is failing to meet its ESG purposes, they are the ones who must step up. Some institutional investors are already promoting ESG goals. BlackRock has announced broad plans to address climate change, including divesting from companies generating more than 25 per cent of revenues from thermal coal. Chief executive Larry Fink says the group is “increasingly disposed” to vote against directors in corporations that have not made sufficient ESG progress.

Voluntary ESG reporting is growing, with a number of large corporations providing sustainability reports in their public filings. And the more information corporations provide in public filings, the more they expose themselves to additional liability — Massey Energy was sued in 2010 over its statements about its commitment to safety as “job one every day”, given the company’s history of safety violations and fatal accidents. The company settled in 2014 for $265m.

But these methods can only accomplish so much. Mr Dodd argues that there is another way that involves government as well, saying, “There are lessons from the financial crisis that could help achieve the goals of stakeholder capitalism” And it is not just lessons, but tools. Stanford academic Graham Steele believes that climate change qualifies as a “systemic risk” to financial institutions under Dodd-Frank, which would empower US regulators to require financial institutions to mitigate climate risk.

We also need to set clear standards for corporations to meet. Voluntary sustainability reporting frameworks are insufficient. Regulators and legislators should be the ones to set the standards, just as they did for bank capital and liquidity after the financial crisis. Private institutions should not have to take the lead. It is the government’s job to look after the interests of society and stakeholders. Congress should act.

The writer is a partner at Arnold & Porter