The way companies report climate risk is changing

Understand how, and why it matters

February 2023

In anticipation of updates to the Securities and Exchange Commission (SEC) proposed rules to standardize US companies' climate disclosures. New analysis by Marsh reveals the changing landscape of climate risk reporting.

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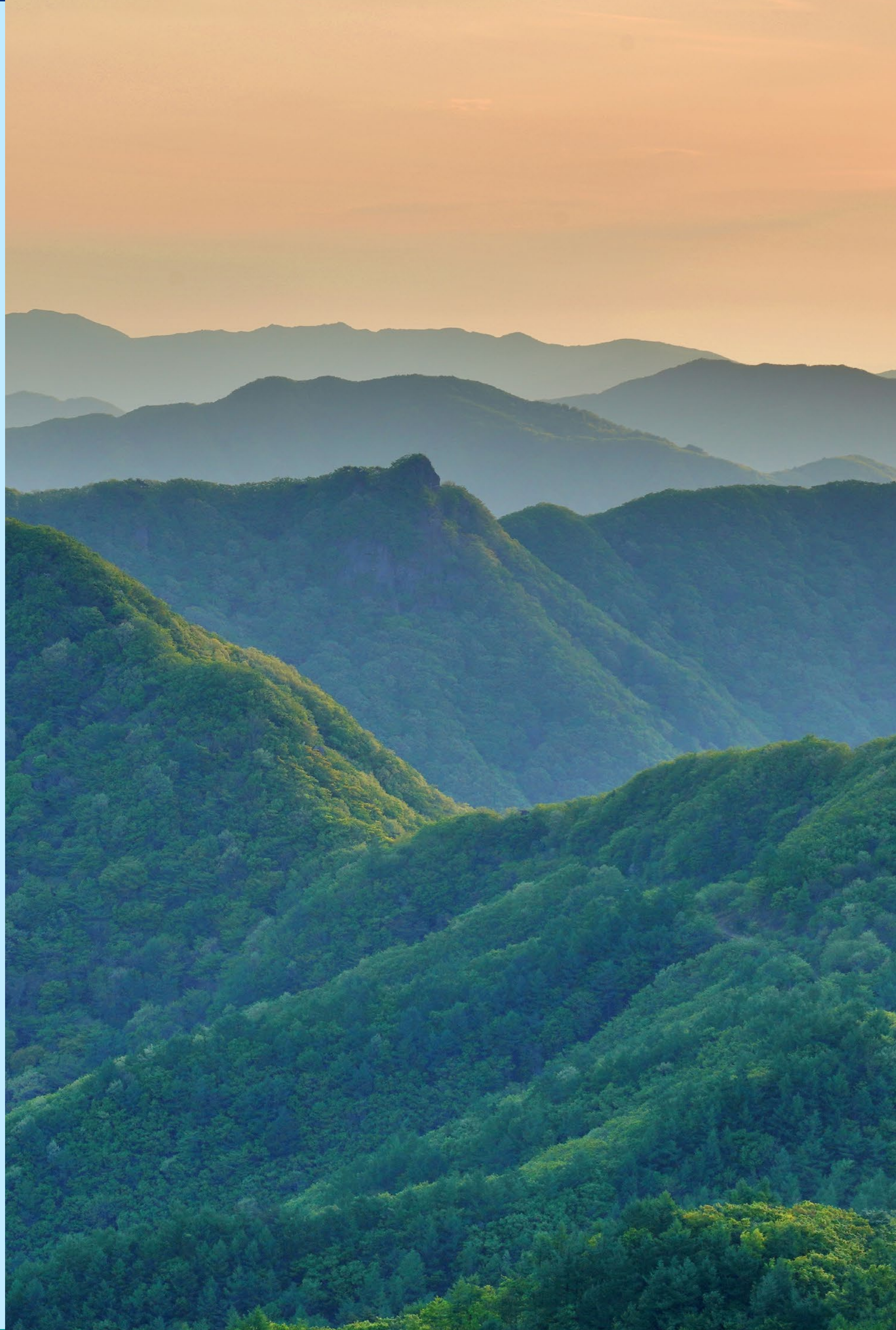
Introduction

Around the world, businesses are waking up to the profound and complex challenges presented by climate change. As a result, transition and physical risks are transforming the ways many companies strategize and operate, including how they monitor, analyze, and communicate climate risk.

So, why is a company's ability to measure and report its exposure to climate risk increasingly in the spotlight? Evaluating these risks allows a company to make better informed decisions on how to allocate capital, and informs strategic planning over various timeframes. What's more, robust and detailed climate risk reporting is increasingly prized — and, in some cases, demanded — by shareholders, investors, and other key stakeholders.



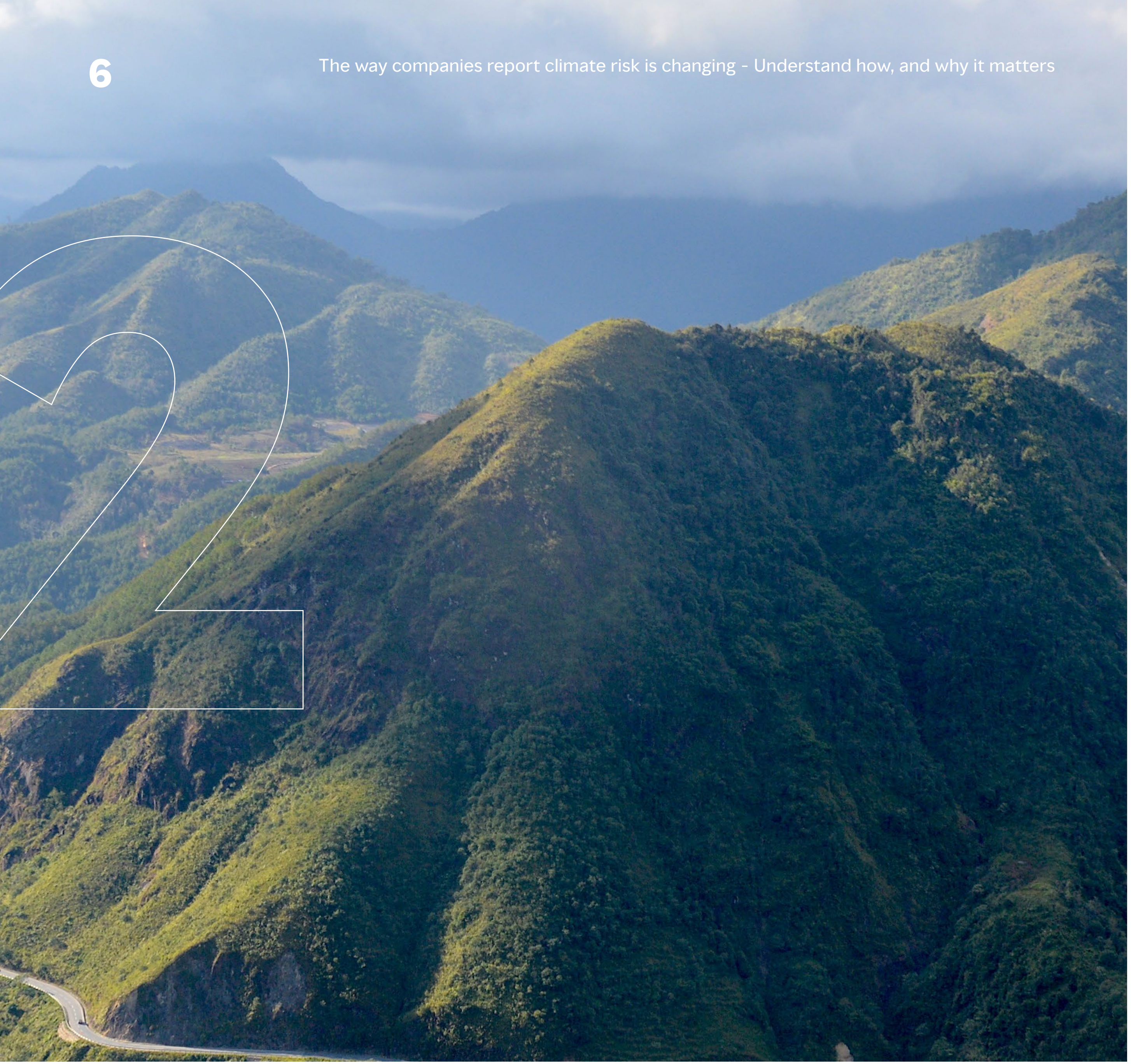
A changing regulatory landscape

Responding to investors' changing expectations and recognizing the risks presented by climate change, government regulators are also requiring greater clarity in companies' climate disclosures.

A new set of rules recently proposed by the Securities and Exchange Commission (SEC), which regulates US securities markets, is designed to shift from companies reporting climate risks on a voluntary basis towards a mandatory model that promotes the use of reliable, consistent, and comparable information disclosures about companies' policies and performance.

By encouraging companies to report to investors in a more transparent and robust way, the SEC's proposal is also designed to compel companies to more thoroughly evaluate and communicate their risk.

On November 10, 2022, the federal government proposed a rule that would require government contractors to publicly disclose their greenhouse gas (GHG) emissions and set emissions reduction goals. These rules would be expansive new requirements for government contractors, going even further than the SEC's proposed climate-related disclosure rules.



Current state of climate risk reporting

Marsh's analysis includes a survey of the total number of companies making climate risk disclosures each year; a breakdown of companies' climate risk disclosures by industrial sector; and a deeper analysis dividing companies' climate risk disclosures into three sub-categories.

The latter comprised regulatory risks, transitional risks (i.e. those relating to the transitional period on the path to net zero), and the risks posed by the physical impacts of climate change itself. Interestingly, this final piece of analysis highlighted a remarkable divergence in the number of physical risk disclosures reported by different industries, suggesting that some sectors are underestimating the significance of the threat they pose.

The aim of Marsh's analysis was to better understand how companies are evaluating and communicating climate risks today. To achieve this, we carried out a detailed review of thousands of filings made by companies between 2008 and 2021, using a two-step analytical process.

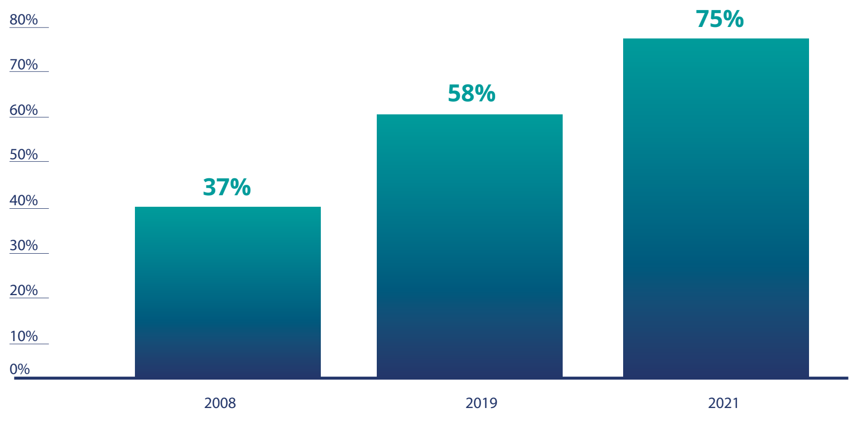
This two-step data analysis, which combined scale with granularity, gives a unique overview of companies' current climate risk reporting behaviors. Here are five of the key insights the research revealed:

INSIGHT 1

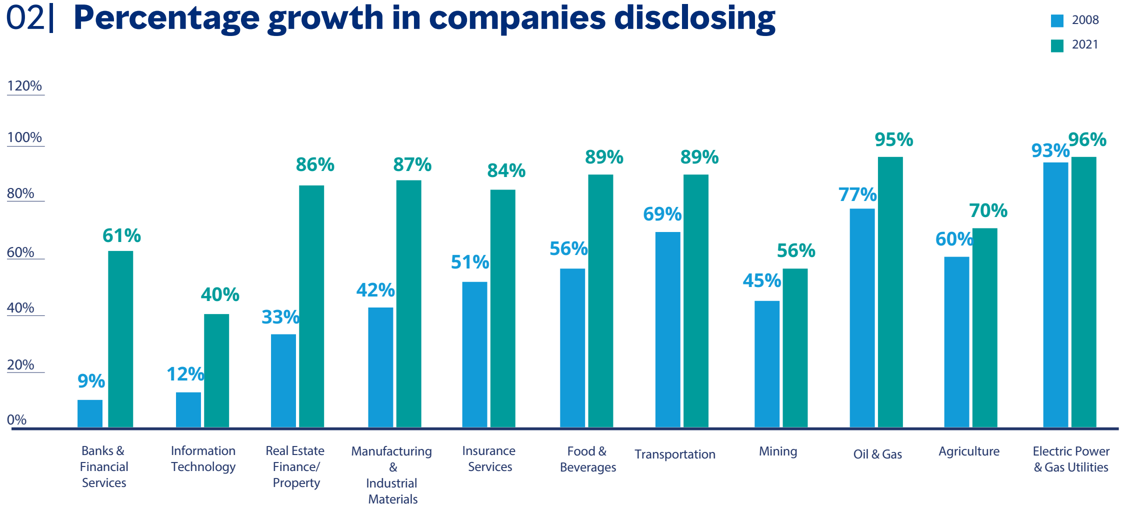
A growing proportion of companies are making climate risk disclosures

Although an overall rising trend in the prevalence of climate risk reporting is unsurprising, it is worth noting that the proportion of companies making relevant climate risk disclosures grew by more than 50% between 2008 and 2019. Of the company filings surveyed in 2008, 37% made relevant climate risk disclosures. By 2021, the proportion of company filings making relevant climate risk disclosures had risen to 75%. This upward trend is likely to continue through 2023 and beyond.

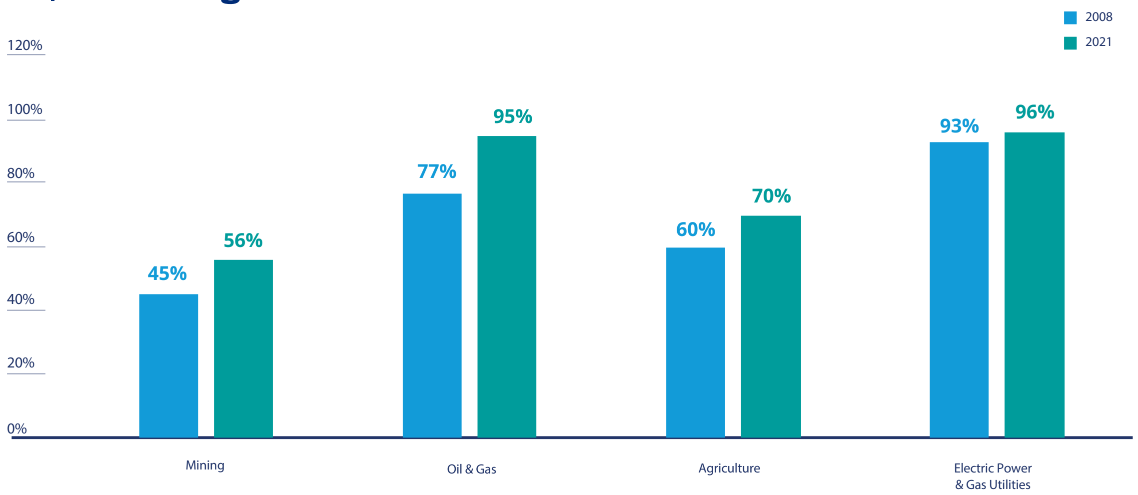
01| Change in percentage of companies that disclose



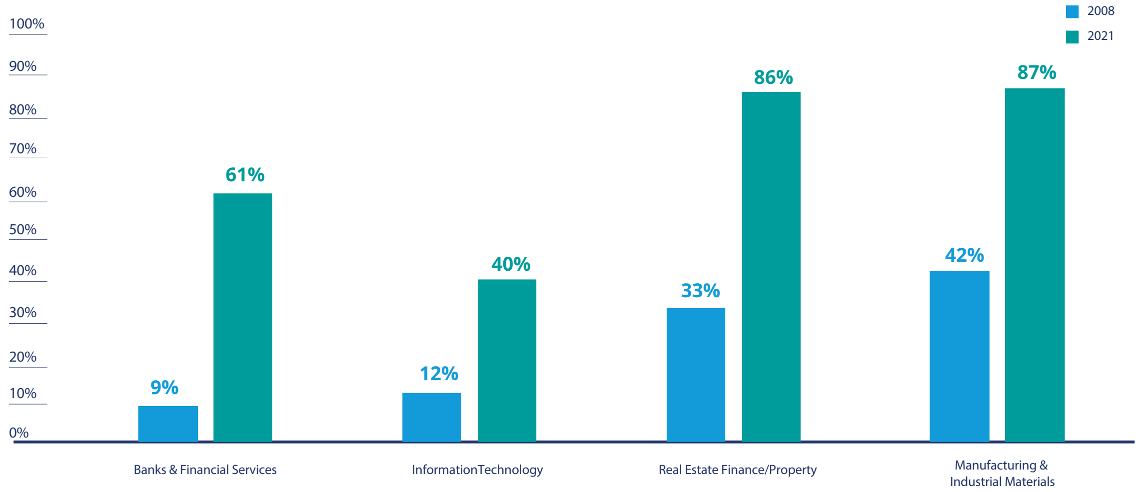
02| Percentage growth in companies disclosing



03| Percentage disclosures across consistent industries



04| Percentage disclosure across industries with greatest change



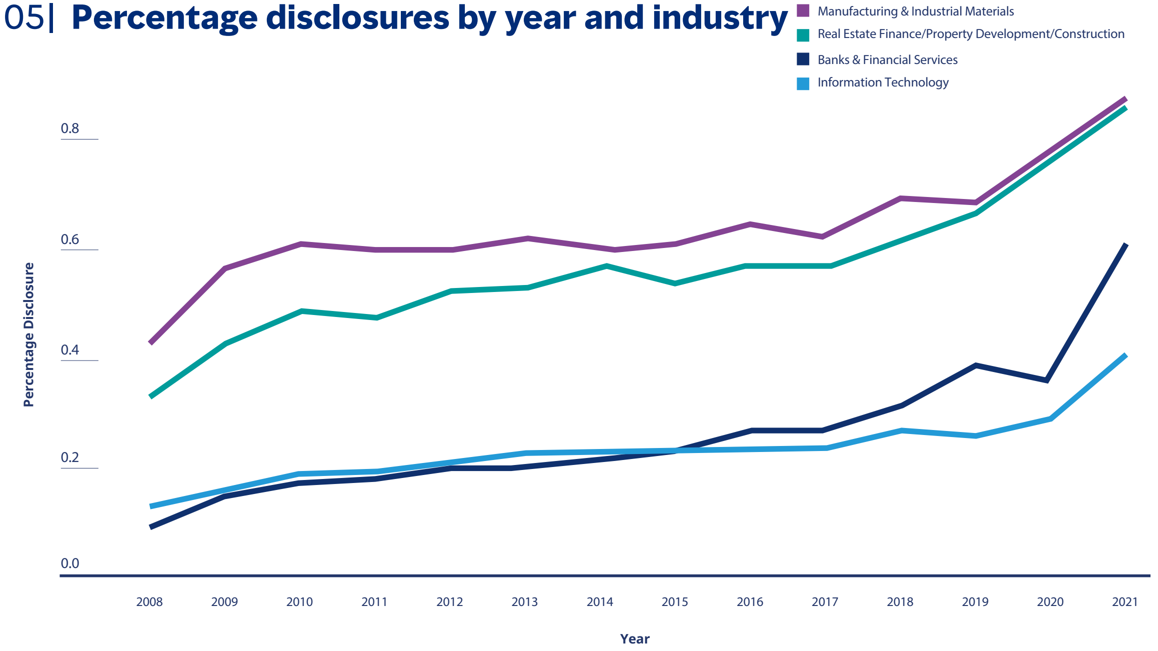
And, as the variety and volume of companies' climate risk disclosures grows, so too does the need for standardized and reliable reporting frameworks. Otherwise, it will become increasingly difficult for investors to draw fair comparisons between companies' exposure to climate risks and gauge their ability to manage them.

INSIGHT 2

Banking, IT, real estate, and manufacturing sectors have seen the most rapid rise in disclosures

Within the overall growth in the number of climate risk disclosures, the recent trends within certain sectors stands out. For example, the percentage of companies in the banking and information technology sectors whose disclosure reporting is aligned with the Task Force for Climate-related Financial Disclosures (TCFD) has risen from fewer than 10% to more than 60% and 40% respectively. The real estate and manufacturing sectors have also seen a doubling of the percentage of companies making climate risk disclosures. See the graph below for an industry-by-industry comparison:

05| Percentage disclosures by year and industry



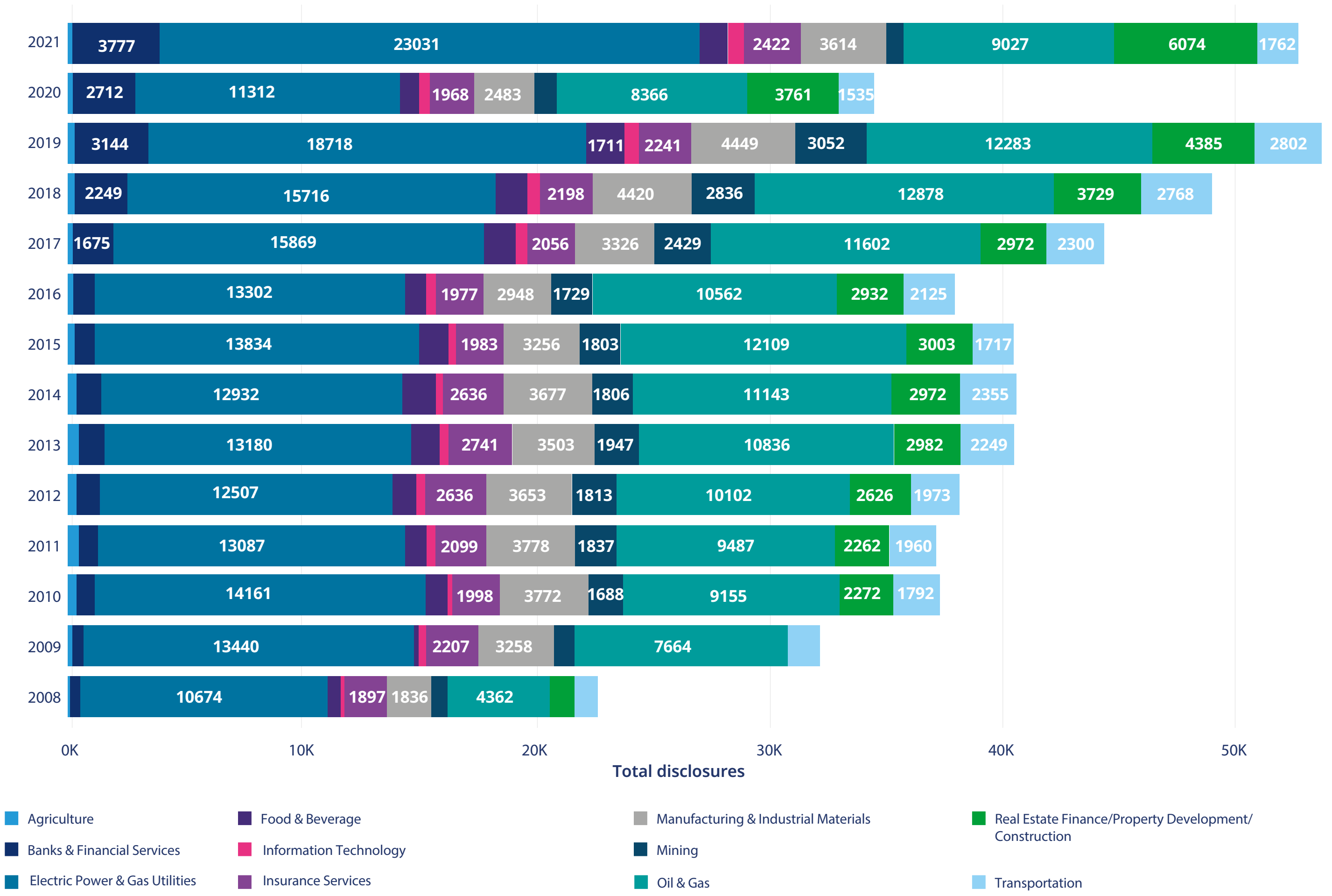
INSIGHT 3

Utility and oil and gas companies are making the most disclosures overall

As you might expect, the largest total number of climate risk disclosures are made by oil and gas and utility companies, where there has been a long-standing focus on climate risk.

It is also interesting to note the steep rise in the number of disclosures made by the banking industry (up from 1.7% in 2008 to 7.2% in 2021) and the real estate sector (up from 4.7% in 2008 to 11.5% in 2021) in recent years. This may reflect the momentum of organizations such as GFANZ, the Glasgow Financial Alliance for Net Zero, which is galvanizing the investment community around climate goals. This trend is illustrated in the graph:

06| Total disclosures by Year and Industry



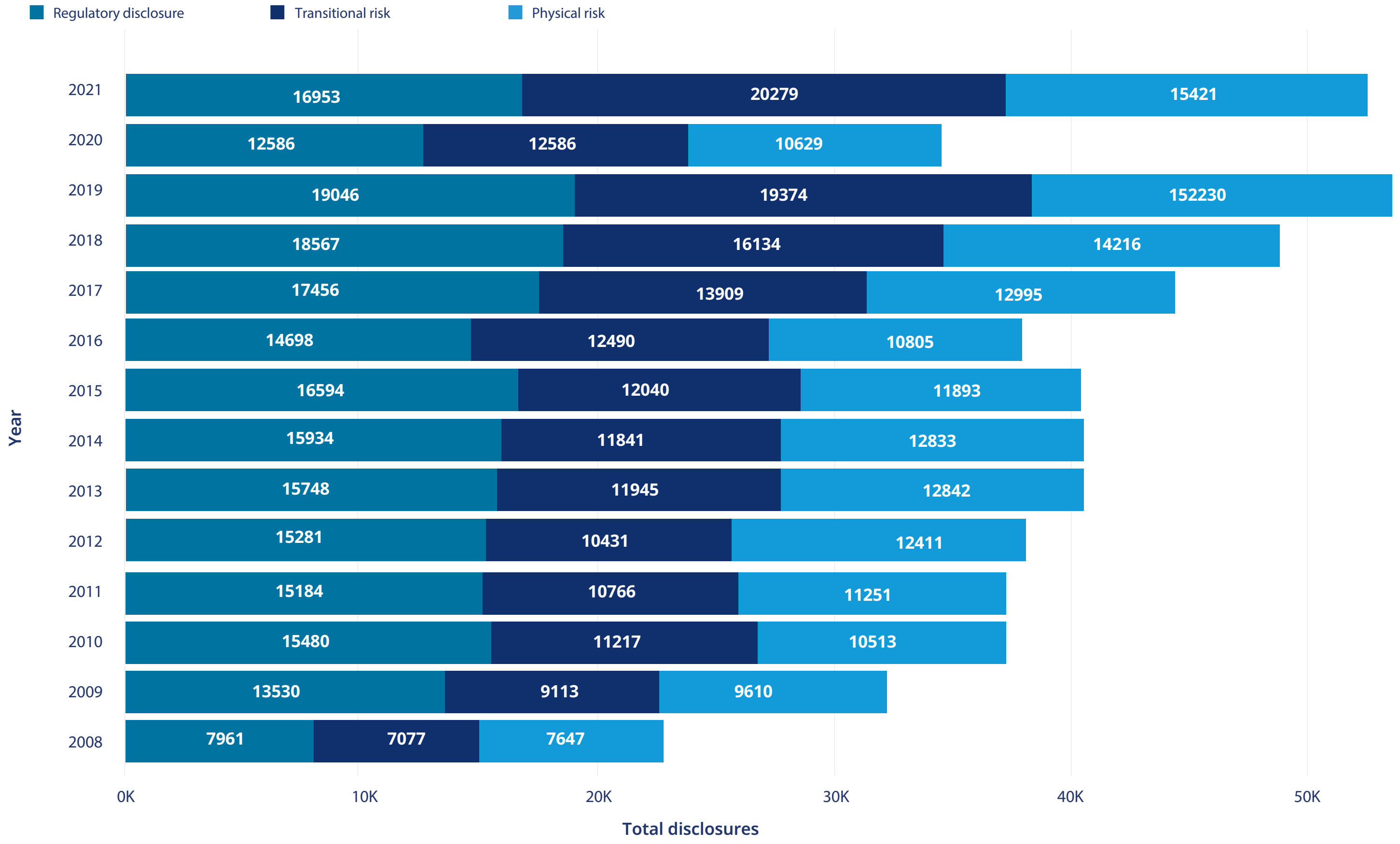
INSIGHT 4

Companies are increasingly referencing transition risk

The number of regulatory risk disclosures made by companies during the period surveyed was largely static, with little increase in those providing more details. And although the total number of physical risk disclosures has risen steadily, it has only done so in relatively small increments.

However, as companies start to grapple with the practical steps they must take on the path to net zero, the number of transition-related risk disclosures has seen a marked increase. Indeed, as the graph illustrates, the number of transitional risk disclosures made in 2021 is almost triple the number made in 2008.

07| Regulatory disclosure, Transition risk, and Physical risk

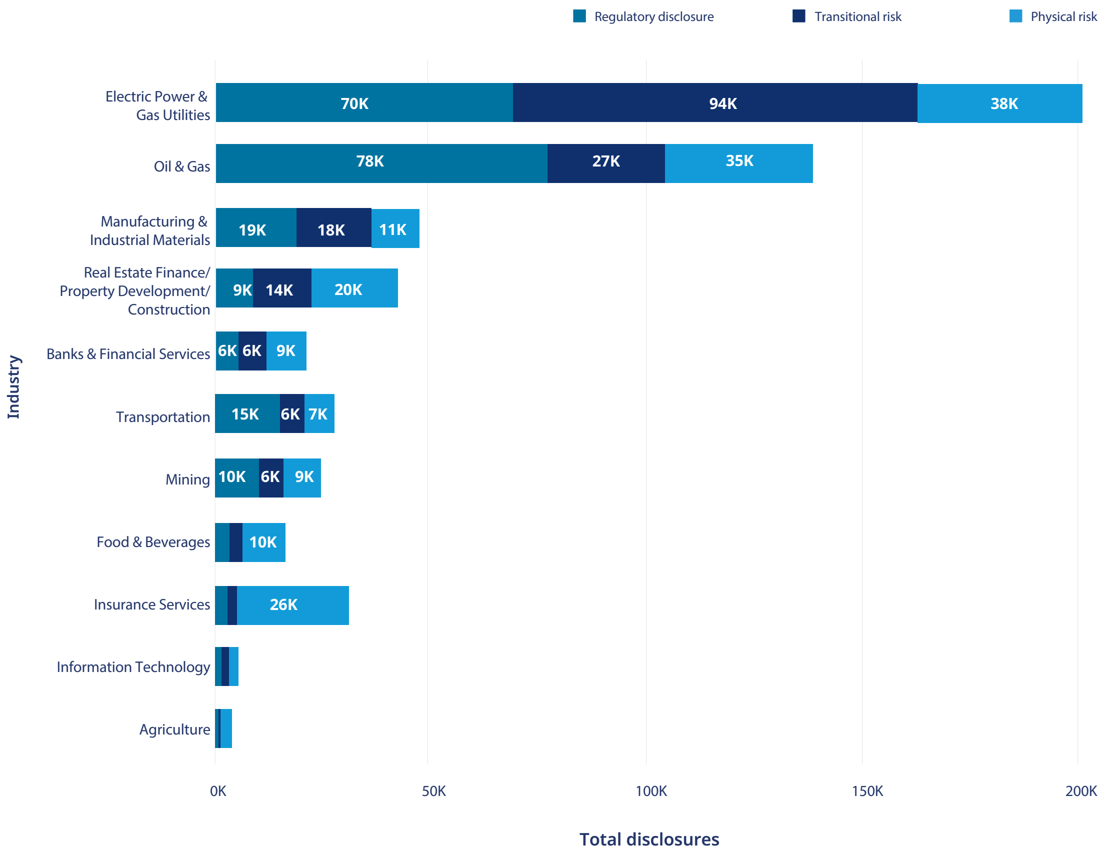


INSIGHT 5

Physical risk is likely under-disclosed

One of the most interesting insights revealed by this analysis is the significant difference between the number of physical risk disclosures made by different business sectors. As you can see from the graph, utility, oil and gas, and insurance companies are currently making the largest number of physical disclosures. This is primarily driven by the fact that these sectors are and have been disclosing risk for a long time. Particularly for utilities and oil and gas, this is as anticipated, since there is a significant and growing expectation on oil and gas companies that they will provide this information. However, physical risk in those sectors would have a tremendous impact on every other sector. Just as we saw with the cold snap in Texas and devastating hurricane Ian, the impacts of severe weather are highly disruptive to mostly all sectors. Therefore other sectors are likely underestimating their exposure to physical risk due to a myopic focus on their own assets versus their entire value chain.

08| Regulatory disclosure, Transition risk, and Physical risk



The higher number of physical disclosures made by insurance companies is understandable, given insurers' crucial role in assessing and then underwriting physical climate risks on behalf of all the other industries.

The in-house expertize that leading insurers have developed in both identifying and quantifying physical climate risks gives them a clearer picture – both of the current impacts of climate change and the scale of the potential problems it could cause companies from different economic sectors in the future.

But again, the insurance segment’s exposure is a reflection of the exposure of other sector’s assets, again indicating that disclosures are driven in part by stakeholder pressure and part by depth of analysis and understanding and are not necessarily an accurate reflection of risk

Conclusion

This analysis would seem to support the SEC's rationale for the proposed rules to shed more light on both the approach to climate risk management as well as disclosure of risk to investors.

Risk is currently not well understood and likely underreported. While the final rules are still to be finalized, there is likely to continue to be an emphasis on greater transparency around climate risk management from a variety of stakeholders, with or without a regulatory mandate.

As the focus on reporting standardization continues to increase, the time is now for engaging in assessment of your climate-related risks. As well as keeping your company on the front foot of regulatory change, a deeper understanding of these risks will build resilience and lead to speedier recovery should the worst happen. At Marsh, we aim to help tackle the underreporting of climate-related risk through our support with physical risk assessment. We encourage all companies to lean on their advisors throughout their transition journeys.

For more information on how these issues could affect your organization, please contact your regular Marsh representative.

THE METHODOLOGY

The first step involved an automated keyword search of company filings to the SEC. We used the CERES Sustainability Disclosure Search Tool to search the text of annual company filings and identify relevant climate disclosures. Once identified, these climate-related excerpts were grouped into one of the following four categories: regulatory risks, transition risks (including renewable energy, clean technology and energy efficiency), physical risks, or as non-specific climate disclosures. This produced both a total number of climate disclosures and a comparison between the number of disclosures that fell into each category.

The second step of our analysis involved training a Natural Language Processing (NLP) model to scan the excerpts from company filings and place each sentence into one of five categories: governance, metrics and targets, risk management, strategy, and none. (Between 70% and 75% of the dataset was deliberately skewed towards being labelled "none", in recognition of the fact that the majority of the information in a company's annual filing will not be related to climate disclosures.)

About Marsh

Marsh is the world's leading insurance broker and risk advisor. With around 45,000 colleagues operating in 130 countries, Marsh serves commercial and individual clients with data-driven risk solutions and advisory services. Marsh is a business of Marsh McLennan (NYSE: MMC), the world's leading professional services firm in the areas of risk, strategy and people. With annual revenue nearly $20 billion, Marsh McLennan helps clients navigate an increasingly dynamic and complex environment through four market-leading businesses: Marsh, Guy Carpenter, Mercer and Oliver Wyman. For more information, visit marsh.com, follow us on LinkedIn and Twitter or subscribe to BRINK.

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