# When governments rescue companies in climate-related distress

*Countries are not acting fast enough to mitigate climate change, which makes it necessary for businesses to focus on adaptation and increases the likelihood that governments will need to step in and rescue firms in distress.* ***Alperen A Gözlügöl*** *analyses possible rescue scenarios.*

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After COP28, the world is now focused on climate change mitigation. Yet, given the slow trajectory of climate action, many doubt whether the ambitious goals of the Paris Agreement, especially keeping global warming at 1.5°C, will be reached.

The world has already warmed 1.1°C, which is projected to reach 3.2°C, current policies standing. That's why, next to climate change mitigation, an important policy goal is climate change adaptation, namely how the world economies can adapt to the impacts of climate change (like floods, droughts, and wildfires that happen at increasing intensity and frequency).

In a recent article, I home in on the problem of under-adaptation to climate risk that is currently argued to be the case for businesses. I argue that such a scenario is likely to lead to governmental rescues of firms for political or systemic reasons, which can in turn feed into the incentives of economic actors not to adapt due to moral hazard, creating deadweight losses.

First of all, climate risk is systemic. It will affect many players in a region or players across regions when events are correlated. This will lead to a 'too many to fail' problem. As modelled in the financial literature, when many actors are on the brink of failure, governments have the same incentives to rescue them as under the scenario of 'too big to fail' for one firm. This is because the economy is not able to absorb the loss to the same extent when only a few companies fail (for instance, their employees can switch and insolvent businesses can be bought out).

Governments might also intervene for political reasons, due to the salience of the event

for the median voter. They will help ailing firms via compensation, grants, loans, and moratoriums in the form of impromptu bailouts and bail-ins instead of mass bankruptcies. Or they will intervene to protect firms against adverse effects. They may fix supply chain issues or lower borrowing costs via interventions in financial markets, such as commercial paper markets and bond buying programs.

As argued elsewhere, restructuring processes are not first-order helps in these cases, as they aim to increase the profit-making ability of distressed firms and reduce their debt level. They cannot remedy the inability of firms to make profits when firms and economies at the micro- and macro-level are still in distress, with damaged assets and infrastructure, little consumer demand, etc.

Also, asset sales, which are usually part of the restructuring process, cannot happen when those assets are climate-stricken. In the extreme, firms might not be viable anymore, for which restructuring will not help at all, and governments need to help ailing economic actors with the setting up of the same (or similar) economic activity in another place. That is not a hypothetical scenario. In recent years, this is exactly what happened in different parts of the world that suffered under different climate-change-related effects.

A similar problem occurs with ‘too big to fail’. While most focus on systemically important firms in the financial system, such firms also exist in the real economy, namely firms that are critically important for various reasons and, therefore, cannot be let to fail. This might be, for example, a regional energy utility firm whose failure would prove disastrous. When these firms are distressed under a climate impact, governments have strong incentives to save them for efficiency reasons or they might find it politically expedient to do so.

An example of a systemically important firm that was distressed and declared bankruptcy is PG&E, one of the largest utility providers in the US, operating in the state of California. PG&E’s infrastructure was not sufficiently resilient against climate-change-induced heat distress. Its poorly maintained equipment caused blazing fires, with resulting damages to human life and property and an ensuing estimated liability of $30 billion.

An insolvency proceeding of a systemically important firm might happen because parties do not internalise its adverse effects on third parties. When liquidation looms large in these cases, the government has strong incentives to lend help. Indeed, in the case of

PG&E, the Californian legislature passed an important law, basically allowing such losses to be borne by ratepayers (like taxpayers in a direct bailout), which then gave investors incentives to restructure the company rather than let it fail.

Such scenarios of governmental rescue are problematic, even though they can be efficient after the fact. They will not prevent deadweight losses (such as lost assets, infrastructure and revenue) and won't prevent associated governmental spending to rescue the relevant firm. They will also create moral hazard when firms know that governments have incentives to rescue them.

This means that they might underinvest in resilience, by either not identifying risks in a satisfactory way or not addressing the identified risks that may befall the firm's operations. Moral hazard, however, depends on the ability of parties vulnerable to the risks of climate change to identify and address those risks, which might not be the case either because the climate risk is too uncertain or they do not have the necessary means to do so.

Given such a bleak picture, I next scrutinise how to provide firms with the necessary information, fiscal help and discipline to adapt to climate change. In this respect, I consider the role of climate risk disclosures, bail-ins and stress testing. The analysis shows that the first two are either weak tools, partly applicable, or they suffer from application difficulties. But stress testing, which would subject firms to a **scenario analysis** involving climate-related events, can be an important tool to build resilience against climate change in the real economy.

Scenarios would draw attention to key events, especially tail risks, and investigate how resilient the system, the sector or the firm is against potential disruptions. Results would expose adaptation gaps and lead to engagement with the relevant firm, sector or region to close this gap, that is, to develop an adaptation plan or take necessary resilience measures, if possible (the so-called corrective measures).

In certain cases, it might be more efficient for the government to take the relevant adaptation measure directly and recoup the costs via taxes on the beneficiaries. In any case, this approach both prevents moral hazard (to the extent it exists) and deadweight losses. The success of this policy is, however, ultimately underlined by the governmental ability to generate verifiable and reliable climate-risk-related information, the capacity for

which governments around the world are building up.

Despite measures taken, governmental rescues of businesses might still occur. This is because measures might not be perfectly workable, or climate impacts might be too uncertain to forecast and prepare. In such cases, there might be a residual role for governments to intervene after the fact, which in turn leads to the need to ensure that any governmental relief program remains fair, efficient and proportionate.

There are already such frameworks in some jurisdictions, for example, the state aid rules in the EU. Still, to alleviate the burden on taxpayers and also on governments that otherwise take substantial debts themselves (which in the worst case trigger the "doom loop"), I recommend creating a rescue fund to which certain firms contribute and from which they can draw when they suffer under climate-related events.

Lastly, I examine whether and how corporate governance can contribute to aligning the incentives for corporate actors such as shareholders and directors with the social interest in climate change adaptation. I see neither institutional investors nor directors as strong monitors with appropriate and sufficient incentives to build resilience and adapt to climate change in the investee companies, which, in turn, strengthens the case for external regulatory discipline.

In conclusion, climate change mitigation rightly attracts much attention from market players, regulators, and scholars. However, there is an acute need to prepare for impacts that remain inevitable and those that will be more likely as mitigation efforts lag. This article contributes to how to address this issue in a socially optimal fashion.

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