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Climate Regulatory Reform and the U.S. Financial Services Sector

SPRING FORWARD EDITION

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Davis Polk & Wardwell LLP

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This deck is one of three that we will update from time to time on key areas of policy development that are likely to affect the U.S. financial services industry.

Our companion publications address Financial Services Regulatory Reform and U.S. Digital Asset Regulatory Reform.

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Looking ahead

Since COP26, 90% of global GDP is covered by commitments to achieve net-zero carbon emissions, with most reductions targeted by 2050. Policy makers in the United States and abroad now must determine how they will deliver on these commitments.

- Addressing climate change is one of the highest priorities of the Biden Administration, and the pace of policy developments is expected to increase in 2022.
- In the United States, policies on climate-related financial risk are still in the early stages of development.
  - The Financial Stability Oversight Council (FSOC) published a Climate Report in October 2021, which stated that "[c]limate change is an emerging threat to the financial stability of the United States" and contained 35 recommendations for FSOC's member agencies.
  - We view the report as a framework for next steps and a call to action, but it is short on details of exactly what the next steps will be, which FSOC's member agencies will likely need to develop in 2022.
- This deck covers a wide range of current and prospective policy developments that are likely to affect the U.S. financial services sector in 2022.

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Biden Administration and Congress

Regulatory action to address climate-related financial risk may increase if the remainder of the Biden Administration's legislative agenda stalls in Congress.

- The Biden Administration published a report in October 2021 specifically addressing climate-related financial risk.
  - The report outlines the administration's whole-of-government implementation strategy, with "a roadmap for measuring, disclosing, managing, and mitigating climate-related financial risk across the economy, including to the Federal Government, while also catalyzing public and private investment to seize the opportunity of a net-zero, clean energy future."
- The Infrastructure Investment and Jobs Act, better known as the **Bipartisan Infrastructure Bill**, which became law in November 2021, called for substantial investments to be made in low/zero carbon infrastructure and technologies, climate change resiliency and other environmental initiatives.
  - "The bill contains very important innovation policy investments whose impacts are difficult to model, but enable deeper cuts in the 2030s and 2040s by helping drive improvement in key technologies like clean hydrogen, carbon capture, advanced nuclear and geothermal, and long duration storage," according to Professor Jesse Jenkins, the head of Princeton's REPEAT Project, as reported by Axios.
- The House passed a version of the **Build Back Better Act** in November 2021 that would go even further, including $550 billion in tax incentives and investments to promote decarbonization, but the bill is currently stalled in the Senate, and it is unclear whether or in what form it may pass.
- President Biden's proposed 2023 budget, announced in March 2022, includes $45 billion to address climate change across the federal government.

Climate risk disclosure

After a year of anticipation, on March 21, 2022 the SEC proposed a sweeping climate disclosure regime for public companies. The comment period closes May 20, 2022.

- Our client alert explaining the proposal and key takeaways is available here. Key takeaways include:
  - Legal challenges are sure to follow adoption, including:
    - Challenges to the SEC's statutory authority; and
    - First Amendment challenges;
  - Some companies may back away from taking steps that trigger additional disclosure obligations under the proposed rule, such as adopting "net zero" and other climate-related targets, using climate scenario analysis or maintaining a carbon price or transition plan;
  - In departing from longstanding principles of materiality, the proposal raises the question of how the SEC might use its authority to mandate disclosure on other hot-button environmental, social and governance topics; and
  - The proposed rules are highly complex, and compliance costs are likely to be significant, which may impact the willingness of private companies to go public.
- We plan to file a comment letter on the proposal and look forward to discussing our clients' concerns.
- Some lawmakers on both sides of the aisle—namely, Republicans on the Senate Banking and Environment and Public Works Committees and Democratic Senator Joe Manchin—have expressed opposition to the proposal.
- Regulatory experience abroad suggests banking supervisors have high expectations for climate disclosures, as the ECB in March 2022 released an assessment finding that banks did not fully meet supervisory expectations.
  - It remains to be seen whether banks will fare better under U.S. regulatory expectations if and when a mandatory climate disclosure regime is put in place.

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Climate risk disclosure: key disclosure requirements

- The SEC's proposed rules would generally require registrants (both domestic and foreign private issuers) to disclose new climate-related information not previously required by the SEC, to be phased in over time (initially with a subset of the requirements applying to large accelerated filers in filings for fiscal year 2023, assuming the rule is finalized in or before December 2022), including:
  - Scope 1 and 2 greenhouse gas (GHG) emissions, expressed in disaggregated constituent GHG and in the aggregate, and in absolute and intensity terms
    - Attestation requirements would apply to these disclosures for accelerated and large accelerated filers, to be phased in over time starting with limited assurance and later reasonable assurance;
  - Scope 3 GHG emissions and intensity, if material, or if the registrant has set a GHG emissions reduction target or goal—potentially including even highly general goals to reduce GHG emissions—that includes its Scope 3 emissions;
  - An issuer's internal carbon price, if the issuer uses one;
  - Information relating to climate risks over the short, medium and long term, and registrants' processes for identifying and responding to such risks, including information regarding registrants' use of and results from scenario analysis, if any;
  - The impact of climate-related events and transition activities on a line-item basis (which would be subject to an audit by an independent registered public accounting firm), as well as the financial estimates and the assumptions impacted by such events and activities;
  - The registrant's climate-related targets or goals, and transition plan, if any; and
  - Information on climate-specific governance.

Climate risk disclosure: common concerns and areas for potential comment

— Certain provisions of the SEC's proposal raise several concerns for issuers, especially for those issuers that already have been engaged in voluntary reporting or non-public work on climate issues. We therefore expect commenters to opine on aspects of the proposal including the following:

- Issuers would be required to disclose non-material Scope 3 emissions simply based on their having set a goal that includes Scope 3 emissions in a voluntary context—while issuers that have not previously disclosed or relied on Scope 3 emissions in voluntary reports or target setting would only need to disclose Scope 3 emissions if material.
- Registrants that use an internal carbon price when assessing climate-related factors would be required to disclose specifics about their internal carbon price, including the price, how it is estimated to change over time, and the rationale for the selected carbon price.
- Registrants that employ scenario analysis would be required to disclose certain information about their use of scenarios. Given prudential regulators' emphasis on scenario analysis (see discussion in the slides to follow), these requirements would likely be particularly meaningful for banking organizations.
- The proposed rules would require disclosure of additional information when a registrant uses carbon offsets or renewable energy credits or certificates (RECs). Specifically, the rules require registrants to disclose the role that carbon offsets or RECs play in the registrant's climate-related business strategy.

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Greenwashing

Fund managers and public companies should expect increased enforcement scrutiny from the SEC regarding ESG investment products and disclosures in 2022.

- Funds that market themselves as “green” or “sustainable” continue to draw increasing levels of investment but in practice can vary widely in the extent to which sustainability factors into their investment decisions.
  - The SEC is considering requiring fund managers to disclose more information about their investment criteria and underlying data. As Chair Gensler stated in July 2021, “the basic idea is truth in advertising.”
  - The SEC announced in March 2021 the creation of a Climate and ESG Task Force in the Division of Enforcement which, among other activities, will analyze disclosure and compliance issues relating to investment advisers’ and funds’ ESG strategies.
  - The SEC and the DOJ have initiated at least one investigation of an asset manager for allegedly overstating the importance of ESG criteria to its investment processes.
  - The SEC Division of Examinations included ESG investing in its 2022 Examination Priorities, with a specific focus on ESG-related advisory services and investment products offered by registered investment advisers and registered funds.
- The SEC is also likely to exercise greater scrutiny over public companies’ ESG claims, particularly where there are significant discrepancies between an issuer’s corporate social responsibility (CSR) reports and its SEC filings or when such claims relate to their net-zero commitments.

Looming conflicts between "fair access" laws and ESG commitments

Fair access laws may complicate banks' commitments to address climate-related financial risks.

- The OCC had previously intended, under the Trump Administration, to finalize a fair access rule, which would have expressly required banks to conduct risk assessment of individual companies, rather than make broad-based decisions affecting whole categories or classes of companies, when provisioning access to services, capital, and credit.
  - A decision to finalize the rule was announced during the final days of the Trump Administration, less than eight weeks after it was proposed, but the rule was put on hold under the Biden Administration before it took effect.
- A growing number of GOP-led states have enacted or introduced measures with similar intent and effect, in response to the perception that banks are reluctant to provide credit to certain industries, such as fossil fuels or firearms.
  - In Texas, for example, Senate Bill 13 requires written verification, as a condition of entering into government contracts, that a company does not and will not "without an ordinary business purpose . . . tak[e] any action that is intended to penalize, inflict economic harm on, or limit commercial relations with" another company because it is a fossil fuel-related business. The bill has been in effect in Texas since September 2021.
  - As another example, West Virginia Senate Bill 262 would have the state Treasurer maintain a "restricted financial institution list" of financial institutions "engaged in a boycott of energy companies." The West Virginia Treasurer would have authority to disqualify restricted financial institutions from bidding on banking contracts, to refuse to enter into banking contracts with restricted financial institutions and to require as a condition of any banking contract with a restricted financial institution that the financial institution not "engage in a boycott of energy companies" while the contract is in effect. The bill takes effect in West Virginia in June 2022.

Looming conflicts between "fair access" laws and ESG commitments

U.S. policy makers have pushed back on suggestions that supervision and regulation may provide an avenue to advance political or social objectives beyond the scope of banking organizations' risk management.

- Senior officials have maintained a consistent message in their public statements responding to concerns that supervisory and regulatory processes may be used to discourage banking organizations from lending to carbon-intensive companies. Notable examples include:
  - Vice Chair-nominee Brainard stated at her confirmation hearing in January 2022: "We would not tell banks which sectors to lend to or which sectors to not lend to," and "we don't do environmental policy at the Federal Reserve. As you say, it's not our expertise. What we do have responsibility for is making sure that supervised institutions are properly risk managing."
  - Secretary Yellen stated at a House oversight hearing in March 2021: "[C]limate change is a top priority for the Biden Administration, but we agree that financial regulators should be assessing the risks to financial institutions through stress testing and other techniques, and that investors need disclosure of risk, but have no plan to regulate what lending or investments can be done."
  - Chair Powell stated in a letter responding to questions from Rep. Barr in January 2021: "We would note that it has long been the policy of the Federal Reserve to not dictate to banks what lawful industries they can and cannot serve, as those business decisions should be made solely by each institution."

Climate risk management and bank supervision

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Supervisors are developing guidance on climate-related financial risk management, and banking organizations will be expected to continue developing their capabilities in this area.

- Climate-related financial risk will be an area of focus for the U.S. banking agencies in 2022, as discussed by the agencies' general counsels at a panel in January 2022. We quote Federal Reserve GC Mark Van der Weide here on two key points, recognizing that the other speakers also expressed similar views:
  - Unlike some non-U.S. central banks, "the Fed does not have a statutory mandate to green the financial system, so to speak. That said, we do have a mandate to make sure that the U.S. banking and financial systems are protected against all material risks. That includes any potential risks from climate change, physical or transition."
  - On the importance of coordination across agencies: "we'll be at our best if we can all stay on the same page as to how we supervise the banks' work to make sure that they're resilient to climate risk."
- Two significant proposals with supervisory guidance on climate-related financial risk have been released to date:
  - The Basel Committee on Banking Supervision (BCBS) released a public consultation on "Principles for the effective management and supervision of climate-related financial risks" in November 2021. The comment period closed February 16, 2022.
  - The OCC also released draft Principles for Climate-Related Financial Risk Management for Large Banks in December 2021. The comment period closed February 14, 2022. In March 2022, Acting Comptroller Hsu stated that the Principles will be finalized in 2022, followed by more detailed interagency guidance with the Federal Reserve and FDIC.
  - The FDIC in March 2022 proposed its own Principles for Climate-Related Financial Risk Management for Large Financial Institutions. They are nearly identical to the OCC Principles but would apply only to the few institutions primarily federally regulated by the FDIC (chiefly state nonmember banks) that have over $100 billion in total assets. Comments are due by June 3, 2022.
- The next slide discusses the proposed BCBS and OCC Principles (as the FDIC Principles are nearly identical) in further detail.

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Climate risk management and bank supervision

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The BCBS and OCC Principles are closely aligned, and their development will likely have a significant influence on the other U.S. banking agencies' supervisory guidance.

- The OCC Principles provide "a high-level framework for the safe and sound management of exposures to climate-related financial risks, consistent with the existing risk management framework [in] OCC rules and guidance."
  - They are designed to "help bank management make progress toward answering key questions on exposures and incorporating climate-related financial risks into banks' risk management frameworks."
  - The Principles outline the OCC's expectations across six areas: governance; policies, procedures and limits; strategic planning; risk management; data, risk measurement and reporting; and scenario analysis.
- The development of repeatable processes to collect reliable data in business as usual will be a key challenge for the banking sector, and the OCC Principles set a high bar in this area:
  - "Sound climate risk management depends on the availability of relevant, accurate, and timely data . . . Data, risk measurement, modeling methodologies, and reporting continue to evolve at a rapid pace; management should monitor these developments and incorporate them into their climate risk management as warranted."
- As supervisory approaches develop at the federal level, we expect that other banking agencies will also take action with respect to banks in their jurisdictions. The New York State Department of Financial Services, for example, outlined its expectations in a Dear CEO letter issued in October 2020.

For more information on how the BCBS and OCC proposals are linked, we recommend the excellent and thoughtful memo published by Debevoise.

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Climate scenario analysis and stress testing

We expect climate scenario analysis to become a key supervisory tool over the medium term, but more work is needed in the near term to develop models, frameworks and methods.

- The OCC Principles describe climate-related scenario analysis as "exercises used to conduct a forward-looking assessment of the potential impact on a bank of changes" resulting from climate-related risks, with objectives such as "identifying and measuring vulnerability to relevant climate-related risk factors including physical and transition risks, and estimating climate-related exposures and potential losses across a range of plausible scenarios."
- Chair Powell and Vice Chair-nominee Brainard have drawn a distinction between climate scenario analysis and existing stress tests, including the Comprehensive Capital Analysis and Review (CCAR). Chair Powell stated in January 2022: "I would stress that those are very different from the regular stress tests which affect capital. Climate stress scenarios at this stage are really about assuring that the large financial institutions understand all of the risks that they're taking, including the risks that may be inherent in their business model regarding climate change over time."
- We expect that U.S. bank supervisors will attend to the lessons learned from initial exercises conducted by the Bank of England and in other jurisdictions where climate scenario analysis and stress testing are more advanced.
  - The Bank of England launched the Climate Biennial Exploratory Scenario (CBES) in June 2021, and a second round in February 2022, as "a learning exercise [to] explore the vulnerability of current business models to future climate policy pathways and the associated changes in global warming." CBES results are expected to be published in May 2022.
  - The CBES considers three scenarios – early action, late action and no additional action toward net-zero – that build on work done through the Network for Greening the Financial System in partnership with climate scientists.

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Board responsibilities

The boards of directors of banking organizations will face increasing pressure from supervisors around their oversight of climate risks.

- In November 2021, Acting Comptroller Hsu delivered remarks on the "Five Climate Questions that Every Bank Board Should Ask" to promote and accelerate improvements in climate risk management practices:
  1. What is our overall exposure to climate change?
  2. Which counterparties, sectors, or locales warrant our heightened attention and focus?
  3. How exposed are we to a carbon tax?
  4. How vulnerable are our data centers and other critical services to extreme weather?
  5. What can we do to position ourselves to seize opportunities from climate change?
- The OCC plans to elaborate on the draft Principles in subsequent guidance that will distinguish the roles and responsibilities of boards and management, and it may require compliance with such guidance under its Heightened Standards.
- The Federal Reserve may also issue and require compliance with supervisory guidance on climate-related financial risk under the Governance & Controls component of its Large Financial Institutions rating system.
- Any supervisory guidance would not alter directors' fiduciary duties under state law, as discussed on the next slide, but any failure to meet the expectations in such guidance could lead to supervisory pressure.

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Board responsibilities

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From a fiduciary duty perspective, directors should have considerable latitude to oversee and challenge management's establishment and implementation of their organization's climate-related commitments.

- For these actions, the directors are protected by the business judgment rule – a rebuttable presumption that such actions were taken on an informed basis, in the good faith and honest belief that they were in the best interest of the corporation, assuming the directors are independent and disinterested.
  - Under *Caremark* and its subsequent decisions (as discussed in a Davis Polk client update), the Delaware Supreme Court has held that the duty of good faith includes a duty to oversee risk management programs for mission-critical risks.
  - One SEC Commissioner has suggested that directors of carbon-intensive companies might face liability under Caremark, if climate change is a mission-critical risk and if they fail to oversee a climate risk management program.
  - Climate-related financial risk, however, is unlikely to be considered a mission-critical risk for most companies, absent legal, regulatory or supervisory mandates and consequences.
- Boards also should not assume that all regulators and public officials will move in the same direction or on the same timeline.
  - Professor John Cochrane, for example, argues in the National Review that climate change poses no meaningful risk to financial stability, and Senator Toomey has cited his views in arguing that efforts to address climate risk should be outside the purview of financial regulatory policy.

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Capital risk-weight incentives

U.S. regulators will be reluctant to adjust capital risk-weights to incentivize green lending unless such changes are adopted as international standards by the BCBS.

- Graham Steele, the Assistant Secretary of the Treasury for Financial Institutions, has previously advocated for such changes.
  - He acknowledged that “the foundation that clean investments are, in fact, less financially risky has yet to be established” and that using capital risk weights to influence outcomes “would transform climate risk from a financial risk-focused frame to a social goal that is divorced from an underlying empirical foundation.”
  - He nonetheless argued that “[r]isk weights could be increased for loans and investments in climate change-driving assets,” citing the negative externalities created by climate change-causing financial activities and risk of a “climate Lehman moment” requiring “[p]ublic expenditures to mitigate the damage of a climate crisis.”
- The U.S. banking agencies, however, have signaled no support for such measures to date. Chair Powell and Vice Chair-nominee Brainard repeatedly signaled during their confirmation hearings that, in their view, climate-related financial risk is relevant to banking organizations’ risk management but should not affect their capital planning or capital requirements.
- Climate-related financial risk remains an important topic of research and analysis by the BCBS, which in April 2021 released two analytical reports: “Taken together, the reports conclude that climate risk drivers can be captured in traditional financial risk categories. But additional work is needed to connect climate risk drivers to banks’ exposures and to reliably estimate such risks. . . . Building on this analytical work, the Committee will investigate the extent to which climate-related financial risks can be addressed within the existing Basel Framework” of capital requirements.

Federal Reserve Board | Biden's nominees

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Climate policy will be a priority for the Federal Reserve in 2022, but the extent and substance of further developments will depend on whether Biden's nominees to the Federal Reserve Board are confirmed.

- President Biden had nominated Lael Brainard as Vice Chair, and Sarah Bloom Raskin as Vice Chair for Supervision, both of whom support the Federal Reserve taking a more proactive role in addressing climate risk.
  - Brainard, a current Fed Governor, highlighted the benefits of climate scenario analysis, among other measures, in an October 2021 speech, stating that it "will be important to systematically assess the resilience of large financial institutions and the broader financial system to climate-related risk scenarios."
  - Raskin, a former Governor and deputy Treasury secretary, has been outspoken in her public statements on this topic:
    - In May 2020, she criticized the Federal Reserve for permitting fossil fuel companies to access its emergency lending programs, and later stated that "[i]f the Fed were to insert objective criteria, and ran its potential purchases through those criteria, then what would be excluded would be more than fossil-fuel company debt. And that would be the right result."
- The effort to vote Biden's nominees out of the Senate Banking Committee initially stalled.
  - After receiving opposition from Senator Toomey, Senator Manchin and others, Raskin withdrew her nomination for Vice Chair for Supervision.
  - Following Raskin's withdrawal, the other nominees, including Powell and Brainard, were advanced out of committee.
  - Confirmation votes are expected shortly after the Senate returns on April 25, 2022, with a vote on Brainard or Lisa Cook to come first, followed by Powell and Philip Jefferson, whose nominations have been less controversial.
  - It remains to be seen whom Biden will nominate as an alternative to Raskin as Vice Chair for Supervision.

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