Davis Polk

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

FALL FOCUS EDITION

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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

The move towards a net-zero carbon future by 2050, as committed to by 90% of global GDP since COP26, continues but the world has changed a great deal since our last update. The Russia-Ukraine war, volatility in energy prices and anticipated troubles in Europe as winter approaches are likely to hinder countries' climate-related efforts in the near-term.

- In the United States, recent legislation, which contains compromises about fossil fuels, means that regulatory action by the banking and other agencies will continue.
  - The **Inflation Reduction Act of 2022**, which was a more modest version of the Build Back Better Act proposed in November 2021 and which became law in August 2022, included $369 billion in tax credits and investments designed to incentivize the development of renewable energy and greenhouse gas (GHG) reduction technologies and a program imposing fees on methane emissions from oil and gas facilities, as discussed in our client update.
  - Senator Manchin and congressional leadership have agreed to consider future legislation to ease federal permitting of energy-related projects by the end of September 2022—though its content, and its prospects for passage, remains unclear at this point.
  - President Biden's proposed 2023 budget, announced in March 2022, includes $45 billion to address climate change across the federal government.

SEC: climate risk disclosure

The SEC has proposed a sweeping and controversial climate disclosure regime for public companies. The SEC's extended comment period closed on June 17, 2022 and received over 14,000 letters, garnering significantly more interest than the usual SEC proposal.

- 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 costs may impact the willingness of private companies to go public.
- We filed a comment letter on the proposal discussing our clients' concerns.

SEC: 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.
  - In May 2022, the SEC announced two proposals, which were analyzed in our client update. As Chair Gensler stated in July 2021, "the basic idea is truth in advertising."
    - One proposal requires certain investment advisers, registered investment companies and business development companies to provide standardized ESG disclosures, including requiring certain ESG-focused funds to disclose GHG emissions related to their investments.
    - The other proposal, among other things, expands upon the Names Rule (i.e., requiring funds with a name that suggests a particular focus to adopt a policy to invest at least 80% of their assets in a manner consistent with such suggested focus), including addressing the use of ESG terms in fund names.
  - 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 has pursued investigations of or enforcement actions against at least three banking organizations' assets managers in the past year for allegedly overstating the importance of ESG criteria to their 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

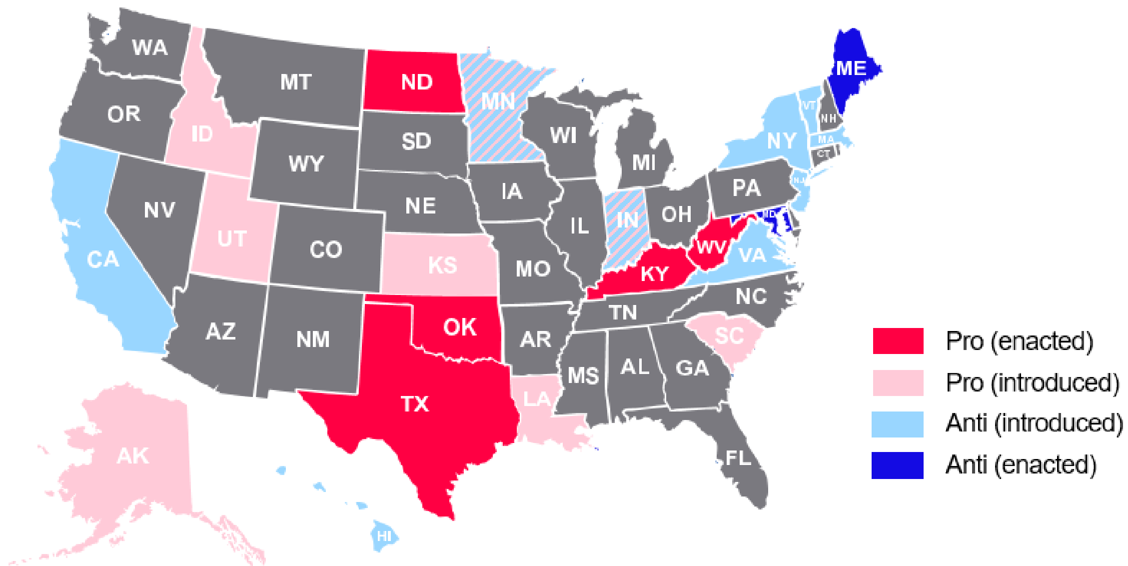
Fair access laws may complicate banks' commitments to address climate-related financial risks.

- 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 was published in the Federal Register.
  - In a recent D.C. Circuit decision, a divided panel held that a final rule becomes final when made available for public inspection, not when published in the Federal Register. As such, it is an open point whether the Trump Administration's fair access rule exists as a binding regulation.
- 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.
  - A similar bill was signed in Kentucky in April 2022.

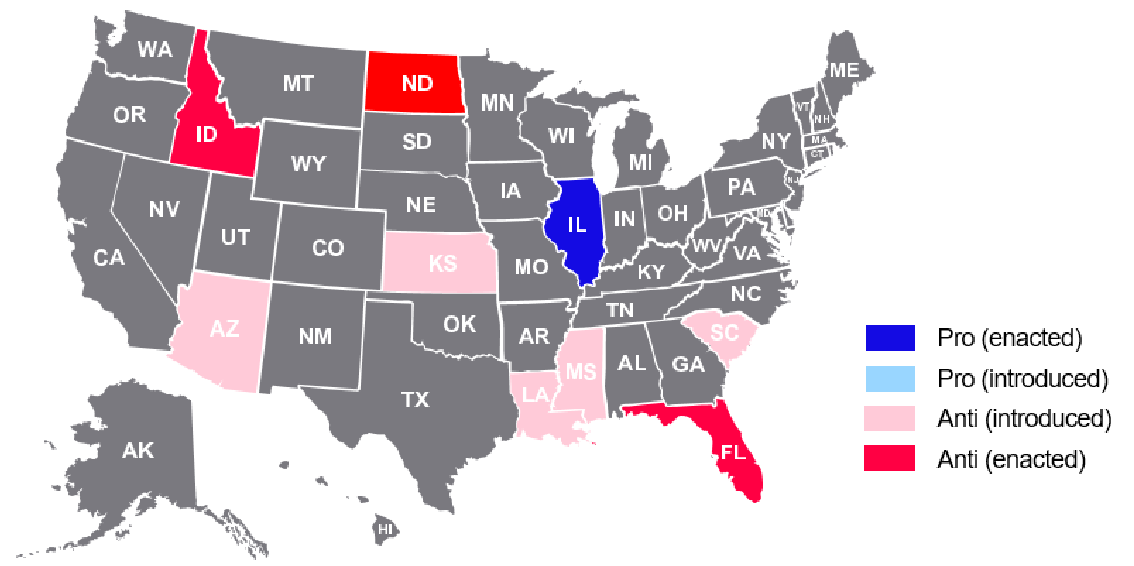
Looming conflicts between fair access laws and ESG commitments

– As of late August, many states have considered or passed legislation weighing on these issues. For example:
  - **Pro-oil and gas** legislation restricting the government from investing or doing business with entities that are divesting from or not doing business with fossil fuel companies.
  - **Anti-oil and gas** legislation restricting the government from investing or doing business with fossil fuel companies.
  - **Pro-ESG** legislation requiring the government to consider ESG factors for investments.
  - **Anti-ESG** legislation restricting the government from considering ESG factors for investments.

Oil and gas legislation



ESG legislation



As of August 27, 2022

For more information on developments in anti-ESG state legislation, we recommend this blog post published by Morgan Lewis.

Banking agencies: climate risk management

Several significant proposals with bank supervisory guidance on climate-related financial risk have been released to date but none of the U.S. banking agencies' have been finalized.

- The Basel Committee on Banking Supervision (BCBS) released its final Principles for the effective management and supervision of climate-related financial risks in June 2022, following its public consultation in November 2021.
- The OCC also released draft Principles for Climate-Related Financial Risk Management for Large Banks in December 2021. The comment period closed February 2022. In March 2022, Acting Comptroller Hsu stated that the OCC 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. The comment period closed June 2022.
- The Federal Reserve has not announced its own climate-related financial risk management principles for large financial institutions.

Banking agencies: 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 BCBS Principles contemplate both company-run and supervisory climate-related risk scenario analysis and stress testing.
  - For banks, scenario analysis should be used "to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile."
  - For supervisors, scenario analysis should be considered "to identify relevant risk factors, size portfolio exposures, identify data gaps and inform the adequacy of risk management approaches," as well as "to evaluate a firm's financial position under severe but plausible scenarios."
- 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 Brainard have drawn a distinction between climate scenario analysis and existing stress tests, including 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."

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Lessons from the Bank of England scenario analysis

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 noted at the outset that "Expertise in modeling climate-related risks is in its infancy, so this exercise will develop the capabilities of both the Bank [of England] and [Climate Biennial Exploratory Scenario] participants."

- The Bank of England released the results of the second round of its Climate Biennial Exploratory Scenario (CBES) in May 2022.
- In announcing the results, Bank of England Deputy Governor for Prudential Regulation and CEO of the Prudential Regulation Authority Sam Woods prefaced, "While capital can address the financial consequences of climate change, we don't think it is the best tool to address directly the causes of climate change—for example by reducing capital requirements to subsidise 'green' assets, or increasing them to penalise carbon-intensive ones. How to address the causes of climate change is a decision for governments and parliaments, not financial regulators."
  - In his view, two categories of gaps might need to be addressed in order to confirm that the capital framework effectively accounts for climate risk:
    - regime gaps, "occur[ring] when the design, methodology or scope of the capital framework does not adequately cover risks from climate"; and
    - capability caps, whether "firms and regulators have the data and modelling abilities to ensure it is captured in practice."
- The CBES was intended to assist with responding to capability gaps and considered 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.
- As Deputy Governor Woods summarized, "While they vary across firms and scenarios, overall loss rates are equivalent to an average drag on annual profits of around 10-15%.... But it bears repeating that based on this exercise the costs of a transition to net zero look absorbable for banks and insurers, without a worrying direct impact on their solvency. By themselves, these are not the kinds of losses that would make me question the stability of the system, and they suggest that the financial sector has the capacity to support the economy through the transition."

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. Chair Powell and Vice Chair 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.

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