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State of Play: Climate Risk

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OUR VIEW	*State of Play:* The Biden-Harris Administration will bring significant changes to the federal government's approach to climate change. President-elect Biden has proposed an ambitious plan to address climate change as he seeks to reach net-zero emissions by 2050 through large-scale investments and initiatives and the use of executive orders (more below). Additionally, Biden has maintained the "personnel is policy" mantra by selecting candidates for administration positions that will embed climate policy into departments outside of the traditional environmental agencies (e.g., John Kerry as Climate Czar, Brian Deese as National Economic Council Director). However, embedding consideration of climate risks into financial regulation is complex and fairly partisan and it remains to be seen how far and fast the Biden Administration can implement changes without proper incentives. Beyond obvious physical threats, the potential implications of climate change on the US economy and financial markets have garnered more recent attention from both financial regulators and the private sector. For example, some large financial institutions have terminated business relationships to align company objectives with recognition of these increasing risks. Similarly, the idea that environmental, social, and governance (ESG) risks, including climate change, are strong predictors of a company's resilience and financial well-being has resonated, although questions around effective disclosure still remain. We expect a more aggressive regulatory stance under the incoming Democratic Administration at both the federal and state levels, as well as proactive sustainability initiatives from corporations, including climate-friendly investments and climate scenario planning, as firms and financial institutions see additional external and social pressures. *Our View*: Fundamental change to the US's approach to climate change will remain a top issue for the Biden Administration across almost every government vertical. In fact, the Biden transition has communicated a focus on climate risk as one of its four pillars in discussions with outside groups. We expect the incoming administration to first focus on areas where they can take immediate action including through executive orders and rejoining the Paris Climate Agreement and to rely on key Administration officials to coordinate regulatory action around climate risk. In the financial regulatory area, we expect increasing focus on regulatory actions and tools that can be used to align with the Administration's focus. The White House, FSOC, Federal Reserve, SEC, and CFTC will play key roles in driving policy and setting expectations for the financial industry to manage and mitigate associated financial risks, although major regulatory actions may be delayed past the first 100 days until we are on a stable path to economic recovery. Comprehensive climate legislation is unlikely to pass in 2021. This is due in part to a likely split Congress and the slim House Democratic majority. Rather, we expect any attempts for congressional action to focus on investments in energy, climate research, and technologies as add-ons to larger, likely bipartisan bills (e.g. appropriations, infrastructure, defense, stimulus). We also expect continued partisan posturing by Congress in its oversight of financial regulatory actions related to climate risks. Below we provide an overview of recent activity at the financial regulatory agencies and what to expect under the new Administration.

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<td>WHAT TO WATCH</td>
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White House

Biden has announced a rigorous plan to tackle climate change and environmental justice. The plan's initiatives include large-scale investments in clean energy research and innovation, international coordination through global climate agreements, and swift recommitment to the Paris Climate Agreement, a move which is not dependent on Senate approval. Biden has also pledged to sign a number of executive orders (EOs) focused on emission reduction and clean energy, as well as to require public companies to disclose climate risks (although this would require SEC rulemaking).
In addition to those outlined in the Biden plan, we could see EOs reversing actions taken by the Trump Administration (e.g. restoring Obama-era methane standards, imposing more stringent vehicle fuel efficiency standards) and directing financial regulators to address climate change and include it as part of their regulatory and supervisory functions.
There is the possibility of an EO that prohibits companies from doing business with certain industries, businesses or projects deemed environmentally unfriendly (e.g. oil, fossil fuels, coal). We expect this would be difficult to implement and enforce but the Trump Administration's Nord Stream 2 sanctions could be used as a model. For reference, US lawmakers prohibited companies from facilitating the construction of the Nord Stream 2 gas pipeline, including those providing insurance services.
Former Secretary of State John Kerry will serve as Biden's newly-created Cabinet-level position as special envoy for climate. Kerry will sit on the National Security Council (NSC) and report directly to President-elect Biden. His appointment makes clear that the Biden Administration believes that climate change is a national security issue and that they will focus on global multilateral engagement to tackle this issue.
Biden also plans to appoint a domestic climate change coordinator to work alongside John Kerry and other cabinet secretaries and high-level officials to coordinate a climate action plan. The position will play an important role in guiding the administration's use of EOs and regulatory action as well as impact prospective legislation.
Biden highlights throughout his climate plan that his administration will address climate change as a global challenge that requires decisive action from every country around the world. The US will have to engage not just multilaterally, but with China and other foreign players given the enormity of the situation and need for global commitment. The administration will have to balance the need to partner with China while addressing other longstanding issues.

Department of Treasury & Financial Stability Oversight Council (FSOC)

Under the leadership of presumed Treasury Secretary Janet Yellen, we anticipate FSOC to play a lead role in coordinating and driving a comprehensive discussion on climate risk by the federal financial regulators. We have already seen pressure on Secretary Mnuchin from congressional Democrats to recognize climate change as a systemic and financial stability risk and anticipate this pressure to heighten. While FSOC has tools to force regulatory action (which we discuss below), it has an equally important role in driving the agenda by publicly identifying risks.
In 2021, we anticipate Treasury Secretary Yellen, acting as FSOC chair, to form an FSOC working group to further evaluate and begin building a case on a regulatory response to climate risks. This working group is likely to be compromised of experts from key financial regulators including the SEC, CFTC, and Fed. We expect the FSOC to also use publications and statements to publicly make the case for action in late 2021 or 2022. This will provide agencies cover to act independently, but also serve as the foundation for any comprehensive FSOC action.
Under a Biden FSOC, all the vast tools to respond to systemic risks could be used to address climate change. For example, a Biden FSOC will be able to 1) Issue reports identifying climate risk as a financial stability risk; 2) Recommend or ultimately mandate agencies impose new activity or product regulations on entities in its purview to mitigate climate risks; and 3) Incorporate climate risk exposure assessments into its evaluation of individual entities that may face FSOC designation.

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- An aggressive FSOC agenda could lead to novel and unprecedented ways that agencies address climate risk. For example, a coordinated FSOC approach could lead the FHFA to study and mitigate the impact of climate change on the mortgage markets, the exposure of Fannie Mae and Freddie Mac's loan portfolios, and the risk borne by taxpayers.
- In other parts of Treasury, we anticipate the Office of International Affairs and the Federal Insurance Office (FIO) to remain active in pushing the Administration's climate agenda. At FIO, we anticipate a more public recognition that, catastrophic risk increases for insurers and reinsurers due to more severe changing weather patterns. FIO may support increased standards or regulation to mitigate additional risks through its support of FSOC and its participation in international standard setting bodies like the International Association of Insurance Supervisors. Of note, the IAIS has already recognized climate risk and broader sustainability issues as a key theme for its Strategic Plan 2020-2024. Like FIO, the Office of International Affairs is likely to make response to climate risk a central tenant in its engagement with international standard setting bodies and international forums like the Financial Stability Board, G-7, and G-20. As noted above, these bodies are already inclined to be more aggressive on climate risk and more robust US support may lead to action.

Prudential Regulators

- We expect bank regulators under the Biden Administration to begin focusing more on evaluating climate risk through prudential regulation and supervision of large and complex depository institutions. The Federal Reserve is likely to take a central role among the prudential regulators, though it is in the early stages of studying the implications of climate change for the economy, financial system, and financial stability.
- Looking overseas may provide insight as to what direction the Fed may take – central banks in England, France, and the Netherlands have announced plans to stress test banks for their resilience to climate change as early as June 2021. The Fed has already announced earlier this year that it is seeking to join the international Network for Greening the Financial System, a group of 75 central banks set up to combat climate change.
- We note that Chair Jerome Powell (R) has been increasingly vocal about the Fed's role in handling climate issues ("The public will expect … that in our oversight of the financial system we will account for all material risks and try to protect the economy and the public from those risks. Climate change is one of those risks."), and that his term as Chair ends February 2022, well into the Biden presidency. Governor Lael Brainard (D) has also been vocal about climate change being a financial stability risk and called for the Fed to supervise and regulate banks to assess whether their risk-management systems adequately address material climate risks (e.g. severe weather events disrupting standard clearing and settlement, loan losses due to business interruption and bankruptcies, risks associated with loans to uninsurable properties, activities exposed to climate risks).
- The Fed included climate change as a potential financial stability risk in its November 2020 Financial Stability Report. Notably, it mentions potential bank portfolio exposure to residential and commercial real estate properties that are vulnerable to extreme weather events and sudden asset devaluation upon new information about a region's exposure to climate-related financial risks – "Federal Reserve supervisors expect banks to have systems in place that appropriately identify, measure, control, and monitor all of their material risks, which for many banks are likely to extend to climate risks." We could see bank examiners taking a supervisory focus on these kinds of risk management practices and evaluating portfolio and underwriting exposures to sectors and assets that are vulnerable to climate change, though congressional Republicans are likely to take issue with any politicized restrictions on the extension of services and lending to otherwise creditworthy businesses (we saw strong pushback this month in a letter from a group of GOP lawmakers).
- A Basel Committee task force, co-chaired by the Federal Reserve Bank of New York, is evaluating how the Basel framework incorporates climate risk and is expected to issue recommendations next year, which may include stress tests and heat maps to evaluate financial institutions.

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	Securities and Exchange Commission (SEC) • The SEC could require corporate disclosure of climate risks by amending Regulation S-K, which prescribes certain reporting requirements for public companies and funds operating in the US. Both Democratic SEC Commissioners Allison Lee and Caroline Crenshaw have expressed support for this idea, though it will be a decision of Biden's nominee for SEC Chair as to whether the Commission takes up a rulemaking on this and how much of a priority it will be. • It is difficult to predict timing for such a rulemaking as it depends on who Biden nominates for SEC Chair and how quickly they could get confirmed (Mary Schapiro was confirmed in January while Jay Clayton in May). As it generally takes at least a year to propose and finalize a new rule, we do not anticipate corporate climate risk disclosure requirements to be adopted until 2022 at the earliest. • When the SEC amended Reg S-K during the Trump Administration (a one-year process), Commissioners Lee and Crenshaw specifically criticized the rulemakings for not addressing climate risk and called them a missed opportunity to issue standardized and comparable disclosure requirements. The Commissioners have argued that the current principles-based materiality standard, under which the rule operates, has failed to produce sufficient climate-related disclosures to investors. If their remarks are any indication of the SEC's direction with a Democratic majority, we expect a "new rulemaking … to address climate, human capital, and other ESG risks," as well as for the SEC to establish "an internal task force and ESG Advisory Committee." • The SEC's Asset Management Advisory Committee (AMAC) established an ESG Subcommittee tasked with providing the SEC with recommendations on matters concerning ESG investment products. This month, the Subcommittee proposed potential recommendations focused on issuer and investment product disclosure of ESG information and plans to provide final recommendations for a vote in early 2021. • House Democrats have already marked up legislation (on party-line votes) that would require ESG and climate risk disclosures, and are likely to support regulatory efforts at the SEC if Republicans maintain control of the Senate. To the extent the SEC promotes greater ESG investing and disclosure, we expect congressional Republicans to criticize these efforts on the grounds of the lack of a standardized taxonomy, the regulatory burden on issuers, subjective materiality of certain ESG metrics, and the belief that investment funds should act in their clients' best interests and focus solely on returns. • From an international standpoint, the US has fallen behind its global allies. For instance, the UK announced plans to fully mandate climate risk disclosures for companies by 2025, a decision that received widespread support from major private sector players that are encouraging quicker action in the US. Both the EU and UK have set benchmark dates for ESG disclosure requirements for financial market participants in March 2021 and 2023, respectively. • The SEC could go beyond requiring standardized climate risk disclosures. Commissioner Lee recently said in a November 2020 speech that funds and their advisers, credit rating agencies, and financial accounting firms also warrant the SEC's attention with respect to climate and ESG-related factors. • Quicker action at the SEC could come in the form of guidance on how to measure and disclose ESG information in a standardized form. This would not be legally binding but would still increase pressure on companies to disclose this kind of information. • We expect continued pushback from Republican Commissioners Hester Peirce and Elad Roisman on any proposed changes to ESG disclosure reform in the short-term with arguments that there is no standard definition and that the concept is too complex at this point to lead to meaningful reform. However, the two will not be able to prevent new rules while in the minority.

Commodity Futures Trading Commission (CFTC)

- The CFTC's Climate-Related Market Risk Subcommittee released a report on "Managing Climate Risk in the US Financial System," which included 53 recommendations to mitigate relative risk to financial markets. The effort, initiated by Commissioner Rostin Behnam (D), is the first of its kind from a US government entity and goes beyond just derivatives markets in scope.
- While the report recommends regulators "move urgently and decisively to measure, understand, and address" these risks, we do not expect immediate action at the CFTC. Rather, the Commission will likely prioritize conducting additional research on the risks to the derivatives markets, identifying gaps in the CFTC's regulatory and supervisory framework, and using the report to facilitate the dialogue among private market participants, members of Congress, and financial regulators. Behnam has indicated that apart from carbon pricing, existing statutes already provide US regulators with sufficient, wide-ranging authority to address financial risk.
- Democratic legislators have applauded the report for effectively putting many industries (e.g. tech, finance, insurance) "on notice" by highlighting the lack of sufficient disclosure and the discrepancy between the "CEO-level talk" around climate change and substantive action. While legislative action in this regard is unlikely in the short-term, the idea could spur congressional hearings with private market witnesses forced to testify on their organizations' responses to climate change.
- That said, the report puts a large emphasis on the need for the government to work with financial institutions to implement a pilot climate risk stress test for banks of all sizes, as well as to require insurers to assess how their underwriting activity and investment portfolios may be impacted by climate risks. We saw this in New York, as the New York Department of Financial Services ordered all domestic and foreign insurers operating in the state to develop an approach to disclose climate-related financial risks on their business operations and to begin integrating relative best practices into their risk management and business strategies.
- Like with the SEC, the extent to which the CFTC prioritizes climate change depends on the incoming Chair's agenda. Notwithstanding, we believe the new CFTC Chair will be committed to implementing aspects of the report, while the National Economic Committee will also be coordinating and pushing agencies to act. As FSOC members, the CFTC and SEC will face additional pressure to incorporate climate risk policies.

Congress

- We expect increased focus from congressional Democrats on climate and coordination with the Biden Administration, specifically in the House of Representatives through committees such as House Financial Services, Energy & Commerce, Appropriations, and Ways & Means, among others. Any broad efforts would likely focus on building off of reports released this summer by the House Select Committee on the Climate Crisis and Senate Democrats' Special Committee on the Climate Crisis.
- House Financial Services Committee Chair Maxine Waters (D-CA) has specifically recognized climate change as a part of her legislative agenda for the 117th Congress, with a specific focus on green investments, corporate disclosure, and addressing climate risks to financial stability. We expect climate change to be considered in discussions around reauthorizing the National Flood Insurance Program set to expire September 30, 2021.