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State of Play: Climate Risk Update

April 12, 2021

OUR VIEW	In our December report, we previewed that climate change would be a priority for the Biden Administration and how the federal financial regulators would be empowered to mitigate climate risks to the financial sector. Nearly three months into the new presidency, we have seen this "whole-of-government" strategy begin to be implemented as expected with a focus on executive actions, personnel decisions, and a more aggressive regulatory approach. We anticipate these efforts to accelerate now that President Biden's Cabinet is mostly filled and the Administration pivots from pandemic relief to economic recovery and other campaign priorities. We expect significant pushback from congressional Republicans on these efforts, though their ability to impede progress is limited being in the minority. More importantly, the Biden Administration will have to balance competing priorities within the Democratic caucus on climate issues, particularly from moderate Democrats given the slim majorities in the House and Senate. We advise that while there appears to be growing domestic regulatory recognition of the potential impact of climate change on the financial sector, including from certain Trump Administration holdovers at the agencies, there is hardly a consensus on solutions or what the role of financial regulators to mitigate this risk should be. Our base case still holds that comprehensive climate legislation will not become law in 2021 or 2022, due in part to the slim majorities. Instead, we believe most of the action on climate will be implemented through the regulatory agencies and executive action, not Congress. The most likely path forward for climate legislation is for it to be included as part of a larger vehicle, such as a bipartisan appropriations package or through budget reconciliation with only Democratic votes, like we may see with the Biden infrastructure proposal. We also expect congressional Democrats to continue using hearings to raise climate issues as they relate to committee jurisdiction and providing political cover for the Administration's climate efforts. Below we provide an overview of recent developments at the White House, the federal financial regulatory agencies, and Congress, as well as what to expect moving forward.

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

The White House is coordinating the Administration's climate efforts through personnel decisions and executive actions. These steps generally mirror President Biden's campaign platform and the expectations we laid out in December.
On personnel, John Kerry was named to the newly created position of U.S. Presidential Envoy for Climate, which sits on the National Security Council, while Gina McCarthy was appointed to head the White House Office of Domestic Climate Policy.

Kerry has been leading the effort to organize the Leaders Summit on Climate on April 22-23, which is expected to be attended by the heads of state of 40 countries, though Russia and China have not yet confirmed their attendance. The summit will aim for new global carbon reduction pledges from the participating countries and be prefaced by a number of announcements, including another Executive Order (more below) and the U.S.'s 2030 emissions target under the Paris Agreement. The summit highlights Kerry's visible role within the White House and the Biden Administration's global multilateral approach to climate, which it continues to prioritize and raise in bilateral meetings with foreign leaders. The White House will have to balance the need to partner with countries like China on climate while simultaneously addressing contentious issues like human rights.
As national climate advisor, McCarthy chairs the newly created National Climate Task Force, which includes Cabinet-level leaders from 21 federal agencies and senior White House officials. So far, the task force has met twice and is expected to play a coordinating role for the Administration's "whole-of-government" approach.

On day one of his term, President Biden announced that the U.S. is rejoining the Paris Agreement and issued an Executive Order on Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis. Included in the EO were policies to reduce greenhouse gas emissions, climate change resilience plans, the revoking of the Keystone XL pipeline permit, and freezing regulatory actions from the Trump Administration that are inconsistent with climate-friendly policies. The Department of Labor's rule on ESG investing in ERISA plans was included in the list of regulations to be reviewed. On March 10, the DOL announced that it will not be enforcing the rule.
On January 27, President Biden issued another Executive Order on Tackling the Climate Crisis at Home and Abroad, which calls for comprehensive reforms and a whole-of-government approach to addressing climate change. It includes, among other items, goals like net-zero carbon emissions by 2050, decarbonizing the nation's power sector by 2035, and the creation of the aforementioned National Climate Task Force.
Last month, the White House released a $2.25 trillion infrastructure proposal, the American Jobs Plan. It includes several climate and clean energy provisions, though we note they fall short of the most ambitious elements of the Green New Deal and have already drawn complaints from some like Rep. Alexandria Ocasio-Cortez (D-NY) for not going far enough. Among these provisions are $174 billion to boost the electric vehicle market (including half a million charging stations by 2030), $100 billion to update the country's electric grid, $50 billion for infrastructure resilience, $35 billion in R&D for projects on technologies to mitigate climate change, and $10 billion to establish a Civilian Climate Corps. Ultimately, this is still a proposal and subject to potentially significant revision by Congress, even if it is passed with only Democratic votes via budget reconciliation.
President Biden is reportedly preparing to issue another Executive Order on climate. Though details about the scope, structure, and timing are still emerging, what we know so far is that it may include the following:

The National Economic Council, Treasury, Office of Management and Budget (OMB), and the White House Office of Domestic Climate Policy to develop a climate strategy for public and private financial assets within 120 days
Treasury Secretary Yellen to coordinate with the other FSOC members to issue a report within six months on the climate efforts within the jurisdiction of each agency

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- OMB to identify the primary drivers of federal climate-risk exposure and develop ways to quantify climate risk for the president's budget projections, and work with the Council of Economic Advisers to assess the government's climate risk exposure
- Climate disclosure within capital markets (John Kerry at an IMF event last week – *"It's going to change allocation of capital. Suddenly people are going to be making evaluations considering long-term risk to the investment based on the climate crisis."*). Note that executive orders have limited legal reach as independent agencies like the SEC are not legally bound to comply and the Commission already has a workstream on climate risk disclosures underway

Department of Treasury & Financial Stability Oversight Council (FSOC)

- Secretary Yellen has used her bully pulpit to speak about climate change and signal a shift in Treasury's engagement from the previous Administration. She has committed to establishing a climate hub within Treasury and hiring a senior official to lead a review of tax policy incentives and financial stability risks related to climate change. Given her visibility on the issue, Secretary Yellen has drawn fire from Republicans on the growing involvement in climate by financial regulators, but she defended these actions as appropriate and emphasized that regulators will not be restricting lending or investment for otherwise creditworthy business or industries.
- We continue to expect FSOC to play a leading role in coordinating and driving a comprehensive strategy on climate risk by the federal financial regulators. Under the Biden Administration, 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.
- On March 31, FSOC held its first meeting since Secretary Yellen was confirmed. Climate change and its potential impact on financial stability was the main topic, with a focus on real estate exposure to extreme weather events and potential vulnerabilities of real-estate linked assets like mortgage-backed securities. Notably, FDIC Chair Jelena McWilliams and FHFA Director Mark Calabria appeared to be supportive of this workstream. Despite the growing politicization of the regulatory agencies in recent years, it appears that the Trump holdovers on FSOC will not use their status as members to obstruct the committee's climate work.

Prudential Regulators

- Like we laid out in December, the Federal Reserve has taken a central role among the prudential regulators on climate risk. While Chair Jerome Powell has been careful to say that the Fed is still in the early stages of studying the implications of climate change for the economy, financial system, and financial stability, we note that he has been increasingly vocal about the Fed's role in handling climate issues and that his term as Chair ends in February 2022, well into the Biden presidency. Chair Powell, Vice Chair for Supervision Randal Quarles, and other Republican regulators appear to be open to engaging in the discussion around climate risk regulation but have drawn a hard line that regulators should not be in the business of making credit allocation decisions with respect to climate.
- We expect bank regulators under the Biden Administration to focus more on evaluating climate risk through prudential regulation and supervision of depository institutions and assessments of 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, portfolio and underwriting exposures to sectors and assets that are vulnerable to climate change).
- After joining the international Network for Greening the Financial System in December, the Federal Reserve launched its Supervision Climate Committee (SCC) the following month to explore how climate change affects the individual banks under Fed supervision and ensures they are prepared to manage climate-related risks. The SCC is chaired by former NY Fed Head of Supervision, Kevin Stiroh. Governor Lael Brainard also announced the Fed's plan to establish a Financial Stability Climate Committee (FSCC) to identify and address climate-related risks to financial stability from a macroprudential perspective.

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	• On climate stress tests, both Governor Brainard and Secretary Yellen have hinted at climate "scenario analysis" on U.S. banks and insurers, though their comments suggest they would likely be carried out by the Federal Reserve and not impose capital requirements or limit dividend payments as with CCAR. 47 House Republicans have already raised concerns with the Fed imposing climate stress tests, and we expect any efforts by regulators to do so to be met with fierce pushback from congressional Republicans. **Securities and Exchange Commission (SEC)** • With Gary Gensler likely being confirmed as SEC Chair this week, the Commission is expected to continue its workstream to promulgate rulemaking on mandatory climate risk disclosures. This was initiated by Acting Chair Allison Lee, who in February directed the Division of Corporation Finance to begin reviewing the SEC's 2010 guidance on climate disclosures and issued a request for public comment on March 15 with a 90-day comment period. As it generally takes at least a year to propose and finalize a new rule, we do not anticipate climate risk disclosure requirements to be adopted until 2022 at the earliest. • The SEC has been adopting a more expansive role in addressing climate change under thew new Administration. The Division of Examinations included a greater focus on climate-related risks in its 2021 examination priorities and established a Climate and ESG Task Force to develop initiatives to proactively identify ESG-related misconduct. • In line with the "personnel is policy" mantra, Acting Chair Lee hired Satyam Khanna to be the SEC's first Senior Policy Advisor for Climate and ESG. A former member of the SEC's Investor Advisory Committee, Khanna formerly worked for SEC Commissioner Robert Jackson and served on the Biden Transition's Federal Reserve, Banking, and Securities Regulators Agency Review Team. • The SEC's Asset Management Advisory Committee's (AMAC) ESG Subcommittee is continuing to work through their draft recommendations from December to ultimately send to the SEC. These recommendations primarily deal with issuer and investment product disclosure of ESG information and call for the adoption of mandatory standards for ESG disclosures. AMAC's most recent meeting on March 19 included a panel discussion on the December draft recommendations but they were not voted on to be finalized. • 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)** • With President Biden's pick for CFTC Chair yet to be announced, there has been more limited developments on climate-related measures compared to the SEC. Acting Chair Rostin Behnam established a Climate Risk Unit last month to focus on the derivative markets' role in addressing climate-related risk and transitioning to a low-carbon economy. • As we outlined in December, the most significant climate effort at the CFTC was the Climate-Related Market Risk Subcommittee's September 2020 report on *Managing Climate Risk in the U.S. Financial System*, which included 53 recommendations to mitigate financial risks posed by climate change. The report, led by Commissioner Behnam, was the first of its kind from a US financial regulator and goes beyond 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. • The process and extent to which the Commission prioritizes climate change depends on whoever is nominated to serve as CFTC Chair. Notwithstanding, we believe the new Chair will be committed to implementing aspects of the report, while the National Economic Council will

	also be coordinating and pushing agencies to act. As FSOC members, the CFTC as well as the SEC will face additional pressure to incorporate climate risk policies. **Federal Housing Finance Agency (FHFA)** • The FHFA under Director Mark Calabria has notably leaned-in on climate-related initiatives following new leadership in the White House. In the span of a few months, FHFA has hired two environmental economists in its Division of Research and Statistics and issued a Request for Input on the risk of climate change and natural disasters to housing finance and the enterprises, while the Office of Inspector General released a report on *Disaster Risk for Enterprise Single-Family Mortgages*. • As we mentioned above, FSOC held its first meeting last month, where Director Calabria made his most directional comments on climate so far. He said that mortgage finance may be more exposed to climate change than any other part of the financial sector, called it a potentially material risk to the enterprises and taxpayers, and suggested that a capital buffer like the one proposed in the GSE capital rule represents the best protection against this kind of risk. While few would describe Director Calabria as a climate activist, we view his forward-leaning comments as indicative of growing domestic regulatory recognition of the potential impact of climate change on the financial sector, though there is hardly a consensus on solutions or the role of financial regulators to mitigate this risk. • FHFA will largely be in a standstill until the Supreme Court ruling in Collins v. Mnuchin (expected in summer 2021) provides clarity around FHFA constitutionality and whether the director can only be fired by the president "for cause." Until then, Calabria will be in place as director but largely limited in his ability to make any more major changes relating to climate, not to mention the conservatorship of the GSEs. **Congress** • To date, there have been 20 hearings on climate this year across 11 committees in Congress, and certainly more to come. This reflects just how much climate is a priority not just for the Biden Administration, but also Congressional Democrats who now control the agenda in both the House and Senate. Sen. Sherrod Brown (D-OH) and Rep. Maxine Waters (D-CA), the lead Democrats on the Senate Banking and House Financial Services Committees, have each held a hearing on climate and will continue to focus on issues like green investments, climate and ESG disclosures, and climate change as a financial stability risk. • We expect Democrats to continue to use hearings to raise climate issues as they relate to committee jurisdiction, provide political cover for the Biden Administration's climate efforts, and introduce legislation, though few if any are likely able to get the 60 votes necessary to pass the Senate as standalone bills unless they are included as part of a larger vehicle or budget reconciliation is used. Even then, centrist Democrats like West Virginia's Sen. Joe Manchin will effectively have veto power over any bill they oppose. • Conversely, Congressional Republicans are already pushing back on the Biden Administration's climate efforts and what they view as the growing involvement by financial regulators on climate issues (e.g., climate stress tests, climate risk disclosures). We expect Republicans to vigorously exercise their oversight authority over the Biden Administration, sending letters to regulators and criticizing their actions when they appear before the committees. See letters from Sen. Toomey (R-PA) to the SEC, Federal Reserve, San Francisco Fed, and the Export-Import Bank. In the financial services space, criticism from Republicans will center around climate regulation being outside of the jurisdiction of the regulatory agencies, concerns about any politicized restrictions on investments and lending to otherwise creditworthy businesses such as the oil and gas sector, the lack of a standardized ESG taxonomy, the subjective materiality of certain ESG metrics, the regulatory burden of disclosure requirements on issuers, and the belief that investment funds should act in their clients' best interests and focus solely on returns. • Speaker Nancy Pelosi (D-CA) reauthorized the House Select Committee on the Climate Crisis, which is holding its first hearing this session on April 15. Chair Kathy Castor (D-FL) indicated that she plans to advance recommendations from its June 2020 report into policy.