Private sector implications of Biden's Executive Order on Climate-Related Financial Risk

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The Biden **Executive Order on Climate-Related Financial Risk** (the **Executive Order**) is the latest significant step by the Administration to analyze and mitigate the risks that climate change poses to the U.S. economy, businesses, workers and the financial system.[1] It aims to advance the Biden Administration's policy of promoting disclosure of climate-related financial risk, mitigating climate-related financial risk, promoting job creation and social and economic justice goals and reaching net-zero emissions by 2050.

The Executive Order contains directives to various federal regulators to take actions to address climate-related financial risk in five different broad areas: government-wide strategy; coordination among financial regulators; Department of Labor actions to safeguard worker life savings and pensions; federal lending, underwriting, and procurement; and the federal budget. This memorandum focuses on those areas of the Executive Order that are most likely to create risks and opportunities for the private sector. These are, in our view, the impact on the financial sector, which will indirectly impact other sectors, the impact on environmental, social or governance (**ESG**) investing and the impact on those who sell goods and services to the federal government via government procurement.

Assessment of Climate-Related Financial Risk by Financial Regulators

The Executive Order asserts that "[t]he failure of financial institutions to appropriately and adequately account for and measure these physical and transition risks[2] threatens the competitiveness of U.S. companies and markets, the life savings and pensions of U.S. workers and families, and the ability of U.S. financial institutions to serve communities." As such, it reinforces the trend of climate change risks moving from the periphery to the center of the financial agencies' regulatory agenda.[3]

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[1] The emphasis on a whole-of-government approach was articulated by Biden's Tackling the Climate Crisis at Home and Abroad executive order in January 2021 and demonstrated by last month's U.S. International Climate Finance Plan, which we discussed **here**.

[2] Climate-related financial risks encompass both physical risk—that is, the risk of changes in climate (e.g., extreme weather) affecting financial asset values and liabilities—and transition risk—that is, the risk of policies intended to manage or address climate change (e.g., carbon taxes) affecting financial asset values and liabilities.

[3] We discuss this trend, among others, in our deck describing our view of the road ahead for financial regulatory reform under a Biden Presidency. The latest version of the deck is available **here**.

Financial Stability Oversight Council. The Executive Order directs the Secretary of Treasury, as Chair of the Financial Stability Oversight Council (the **FSOC**), to advance the Biden Administration's climate policy by engaging with the other members of the FSOC[4] to consider the following actions:

- Comprehensive assessment on how climate-related financial risk affects "the financial stability of the Federal government and the stability of the U.S. financial system."
- Information sharing regarding climate-related financial risk information among its member agencies. The provision extends the potential reach of the information sharing to "other executive departments and agencies [e.g., the EPA] . . . as appropriate."
- Issuance of a report to the President within 180 days (November 16, 2021) that discusses its member agencies' efforts to account for climate-related financial risk in their policies and programs. The report would discuss the necessity and recommendations to enhance climate-related disclosures of regulated entities, challenges to existing approaches of accounting for climate-related financial risk in regulation and supervision and recommendations on identifying and mitigating climate-related financial risk to financial stability.
- Inclusion into its annual report to Congress an assessment of climate-related financial risk.

Office of Financial Research and Federal Insurance Office. The Executive Order also seeks to re-energize the role of the Office of Financial Research and Federal Insurance Office, both of which had been de-emphasized in recent years. It instructs the Secretary of Treasury to direct the Office of Financial Research and Federal Insurance Office to assess climate-related issues, including helping FSOC to assess financial stability risks. The Office of Financial Research will provide data collection and research development on climate-related financial risks to financial stability. The Federal Insurance Office will analyze the issues as they pertain to the insurance sector, including threats of disrupting private insurance coverage in vulnerable regions.[5]

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[4] The FSOC's ten voting members are: the Secretary of Treasury; Federal Reserve Chair; OCC Comptroller; CFPB Director; SEC Chair; FDIC Chair; CFTC Chair; FHFA Director; NCUA Chair; and an independent member with insurance expertise. There are also five nonvoting members, consisting of: the Office of Financial Research Director; the Federal Insurance Office Director; a designated representative of state insurance commissioners; a designated representative of state banking supervisors; and a designated representative of state securities commissioners.

[5] The Dodd-Frank Act authorizes the Federal Insurance Office to consult with state insurance regulators on "insurance matters of national importance and prudential insurance matters of international importance." 31 U.S.C. § 313(c)(1)(G). The Federal Insurance Office also may assist the Treasury Department in international negotiations of certain bilateral or multilateral agreements regarding prudential insurance matters and determine whether those agreements preempt state laws. § 313(c)(1)(E)–(F). Although not mentioned in the Executive Order, entry into an international climate change agreement that relates to prudential insurance matters could offer the Federal Insurance Office an opportunity to preempt the policy positions of state insurance authorities and the National Association of Insurance Commissioners. *See* Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, Financial Regulation: Law and Policy 428 (2021).

Regulatory Updates to Come. The Executive Order does not set forth any specific policies that financial regulatory agencies must implement,[6] but sends a strong signal of regulatory developments to come for climate change-related issues while outlining a prominent role for the Secretary of Treasury as the FSOC Chair in steering a coordinated financial regulatory agenda. Treasury Secretary Yellen, Federal Reserve Chair Powell, SEC Chair Gensler, Acting OCC Director Hsu, Acting CFTC Chair Behnam and NCUA Chair Harper have all made strong public statements in favor of a more robust regulatory agenda to deal with the risks of climate change. The fact that a majority of the heads of the financial regulatory agencies that make up FSOC membership are likely to be aligned in their thinking implies that pushback is likely to come from Republicans or certain Democrats in Congress rather than from any of these regulatory agencies.[7]

There are many topics being considered or likely to be considered by the Biden-appointed FSOC members, both at the FSOC and at the individual agencies, building on work that began in 2020. Some have argued that the U.S. financial regulatory agencies are trailing the European regulators in their thinking on the risks of climate change. Our view is that the following will be key agenda items:

- The financial regulatory agencies, especially the SEC, will continue to focus on climate change-related disclosures.[8]
- Banking agencies are likely to consider the impact of climate risk on credit concentrations and correlations.[9]
- There will be a debate about whether climate risks are appropriate for stress testing[10] or scenario analysis.[11]

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[6] If the FSOC were to decide on specific policies for its agency members, it could issue a public, nonbinding recommendation to the relevant agency for new or heightened regulations. 12 U.S.C. § 5330.

[7] For example, Republican members of the Senate Banking Committee expressed skepticism about the Federal Reserve's authority to regulate climate change in a March 2021 letter to the Federal Reserve. Letter from 12 Senate Republicans to Jerome H. Powell, Chair of the Federal Reserve Board, Fed. Reserve Bd. (Mar. 18, 2021). *See also* Letter from 47 House Republicans to Jerome H. Powell, Chair of the Federal Reserve Board, and Randal K. Quarles, Vice Chairman for Supervision of the Federal Reserve Board, Fed. Reserve Bd. (Dec. 9, 2020).

[8] For example, the SEC has directed its staff to evaluate its climate disclosure rules and requested public comments by June 13, 2021 to facilitate this review. SEC Chair Gensler has said that he anticipates a proposal on corporate climate risk disclosures later this year. The Federal Reserve has also considered the benefits and limitations of increased disclosure for addressing climate change-related issues. *See* Federal Reserve, *Financial Stability Report* 59 (Nov. 2020)*; see also* Federal Reserve Governor Lael Brainard, *Financial Stability Implications of Climate Change* (Mar. 23, 2021).

[9] An explicit focus on climate risk in credit concentrations is relatively new to banking agencies. "The OCC's Handbook on Credit Concentrations, for example, updated in October 2020, contains no mention of climate change as a credit underwriting risk to consider. By sharp contrast, the New York [Department of Financial Services] has issued a supervisory letter to the banks it regulates stating that it expects enhanced governance around climate risk." Barr, Jackson & Tahyar, *supra note 5*, at 236–237.

[10] *See, e.g.,* Climate Change Financial Risk Act of 2019, H.R. 5194, 116th Cong. (2019); G30, *Mainstreaming the Transition to a Net Zero Economy* (Oct. 30, 2020); Graham S. Steele, *Confronting the "Climate Lehman Moment": The Case for Macroprudential Climate Regulation*, 30 Cornell J.L. & Pub. Pol'y 109, 146–148 (2020). *But see* Letter from 47 House Republicans to Jerome H. (*cont.*)

- It will be interesting to see whether other central banks or financial supervisors will follow suit, particularly the Federal Reserve, which recently joined the Bank of England initiated Network for Greening the Financial System (**NGFS**). The Bank of England has invited large banks and insurers to assess the UK financial system's exposure to climate-related risks against scenarios published by the NGFS, with data submissions due over the course of this year.

- Debates are likely to emerge on whether to apply different capital risk weights to assets based on how much climate-related risk they reflect and whether they promote or inhibit net-zero emissions goals.[12]
- There will likely be a lively debate on whether loans to certain sectors should be encouraged or discouraged, which is likely to be highly controversial.[13]
- Notably, the Executive Order does not mention monetary policy. There is a debate about whether the Federal Reserve has the authority to take climate risk into account under its dual mandate.[14]

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Powell, Chair of the Federal Reserve Board, and Randal K. Quarles, Vice Chairman for Supervision of the Federal Reserve Board, Fed. Reserve Bd. (Dec. 9, 2020); Francisco Covas, *Challenges in Stress Testing and Climate Change*, Bank Pol. Institute (Oct. 19, 2020); Greg Baer, *Climate risk test asks banks to look too far down the road*, Am. Banker (Nov. 30, 2020).

[11] *See, e.g.,* Federal Reserve Governor Lael Brainard, *The Role of Financial Institutions in Tackling the Challenges of Climate Change* (Feb. 18, 2021); Network for Greening the Financial System, *Guide to Climate Scenario Analysis for Central Banks and Supervisors* (June 2020); Bank of England, *The 2021 Biennial Exploratory Scenario on the Financial Risks from Climate Change* (Dec. 2019).

Scenario analysis and stress testing are distinct tools. Stress tests relate to capital distributions and cover only nine quarters ahead, which is shorter than the expected time period for many significant climate change-related risks to arise. Scenario analysis represents a more open-ended evaluation of potential risks across various long-run scenarios. *See* Federal Reserve Governor Lael Brainard, *The Role of Financial Institutions in Tackling the Challenges of Climate Change* (Feb. 18, 2021) ("To be clear, scenario analysis is distinct from our traditional regulatory stress tests at banks. Scenario analysis is an exploratory exercise that allows banks and supervisors to assess business model resilience to a range of long-run scenarios. It seeks to understand the effects of climate-related risks on a range of financial markets and institutions, as well as the potentially complex dynamics among them. By contrast, traditional stress tests are a regulatory exercise to assess the capital adequacy of banks to specific macroeconomic scenarios and financial market shocks over the short-run.").

[12] *See, e.g.,* Steele, *supra* note 10; *but see* George Hay, *Fiddling with Bank Capital Can Help the Planet*, Reuters Breaking Views, (Sept. 27, 2019) (citing challenges with this approach).

[13] *See, e.g.,* Steele, *supra* note 10. But a wide array of Republican members of Congress are likely to vigorously oppose the use of regulatory policy to discriminate in the provision of credit to fossil fuel and other industries that contribute to carbon emissions, as evidenced by the OCC's Fair Access Rule and energetic remarks by Representatives Barr and Zeldin at last week's regulatory oversight hearing before the House Financial Services Committee. *Oversight of Prudential Regulators: Ensuring the Safety, Soundness, Diversity, and Accountability of Depository Institutions: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. (2021). Moreover, Federal Reserve Chair Powell stated in March that "we don't tell banks what legal businesses they can lend to." Jon Hill, *Yellen, Powell Defend Push to Keep Tabs on Climate Risks*, Law360 (Mar. 23, 2021), https://www.law360.com/articles/1367367/yellen-powell-defend-push-to-keep-tabs-on-climate-risks. Similarly, Treasury Secretary Yellen stated in March that there is "no plan to regulate what lending or investments can be done" and "I don't see the FSOC as playing a role in telling financial institutions what kind of lending they can do." *Id.*

[14] Unlike the Federal Reserve, the European Central Bank and Bank of England have environmental considerations explicitly referenced in their mandates. Christina Skinner, *Central Banks and Climate Change* (Oct. 1, 2020). Thus far, the Federal Reserve has not included climate change in its monetary policy. Peter Conti-Brown & David Wishnick, *Technocratic Pragmatism and* (*cont.*)

- Policymakers are sure to face challenges, in light of the lack of verifiable and historical data.[15]
- The Executive Order's mention of disparate impact of climate risks is sure to be a topic of discussion at the FSOC.

In line with its overarching call for a whole-of-government approach to addressing climate change-related financial risk, the Executive Order also calls for a coordinated approach across the financial regulatory agencies facilitated through the FSOC.

Department of Labor and Pension Planning

The Executive Order directs the Secretary of Labor to identify actions that can be taken under the Federal Employees' Retirement Systems Act of 1986 (**ERISA)** and other laws to protect the life savings and pensions of U.S. workers from climate-related financial risk. According to one **estimate**, the total value of retirement assets in the U.S. reached $34.9 trillion at December 31, 2020.

By September 2021, the Secretary of Labor must also consider publishing a proposed rule to suspend, revise or rescind two Trump-era Labor Department rules finalized in 2020, which, taken together, restrict the ability of ERISA fiduciaries – that is, private-sector retirement plan fiduciaries - from selecting and voting on investments based on ESG objectives. The rules took effect in January 2021. The first rule, **Financial Factors in Selecting Plan Investments**, restricts the ability of ERISA fiduciaries to take non-pecuniary considerations, understood to include ESG, into account in investment decisions. The second rule, **Fiduciary Duties Regarding Proxy Voting and Shareholder Rights**, defines whether and how ERISA fiduciaries may vote their proxies in support of ESG matters without justifying or documenting how these votes advance pecuniary interests. The Executive Order's instructions to the Labor Department regarding these rules are in line with other actions and statements by the Biden Administration. For example, on March 10, 2021, the Labor Department **announced that** it intended to revisit both rules and, until it published further guidance, would enforce neither. In addition, Labor Secretary Marty J. Walsh indicated that he intended to reexamine these rules in **written responses** he submitted as part of his Senate confirmation process.

We expect that the Labor Department will propose new rules that will seek to clarify how ERISA fiduciaries are permitted to integrate ESG factors in investment decisions and in managing plan assets while still upholding their fiduciary obligations. Our view is that the Labor Department will have to thread a fine needle in any new rulemaking: on the one hand, the Executive Order, as well as past statements

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Bureaucratic Expertise, 130 Yale L. J. 636, 691 (2021) ("Fed officials have also rejected out of hand any inclusion of climate-change considerations in near-term monetary policy. This has manifested in two ways. The first has to do with the modeling and analysis that informs Fed monetary policy decisionmaking. At present, Fed officials have suggested that climate-driven economic circumstances currently do not play a role in the macroeconomic analyses that drive their monetary-policy decisionmaking. Second, they have rejected calls, growing worldwide, for the adoption of green criteria for financial assets eligible for purchase by the Fed through its open-market operations and discount window.")

[15] *See* Brainard, *The Role of Financial Institutions in Tackling the Challenges of Climate Change*.

from the Biden Administration, express a clear policy preference in favor of integrating ESG into investment decisions. Managers of private investment funds with fund assets subject to ERISA as well as ERISA plan fiduciaries are increasingly being asked by their customers or beneficiaries if they are permitted to invest in more ESG products or vote proxies in support of sustainability proposals.[16] On the other hand, existing law limits the extent to which an ERISA fiduciary may consider non-financial factors in its investment decisions. Accordingly, we would expect that any new rulemaking will:

- echo the broad view of the potential financial impacts of climate risk as well as other ESG considerations articulated in the Executive Order,
- authorize ERISA fiduciaries to take these considerations into account in decision making, *but* only to the extent such factors bear on the value of the investments or where all other factors are equal.

These regulatory outcomes are likely to stand in contrast to the trend in Europe towards mandating rather than authorizing the consideration of ESG factors.[17] Following a similar approach in the United States may require new legislation, which would be a challenge given the current makeup of Congress.

The Secretary of Labor must submit a report to President Biden by November 16, 2021 on the actions taken to in response to the Executive Order's directives.

Opportunities in Federal Procurement

The Executive Order requires the Federal Acquisition Regulatory Council, which is the agency responsible for procurement, to consider amending its regulations to encourage the reduction of greenhouse gas emissions. These amendments would require **all** federal agencies that contract with the private sector "to give preference to bids and proposals from suppliers with a lower social cost of greenhouse gas emissions." While it is not entirely clear how this presidential mandate will be implemented, it is likely to be implemented in part by giving preferences to companies that develop or use technologies that reduce carbon emissions generated as a byproduct of certain manufacturing processes, such as the production of cement or concrete. These preferences would be given in procuring goods and services from the private sector, such as concrete for infrastructure projects. These preferences would provide a financial incentive for the development and use of technologies that reduce the volume of carbon emissions associated with the production of goods and services supplied by the private sector to the federal government.

[16] According to a Schroder's 2021 U.S. Retirement Survey, only 37% of defined contribution plan participants said they are offered ESG-related investment options by their employer. Of those who were aware of these options, 90% said they invested in them. Of those who said their plans did not offer ESG investment options or of those were did not know, 69% said they would increase their overall contribution rate it they were offered ESG options.

[17] Michael Katz, *ESG Becoming the New Normal for European Pensions*, Chief Investment Officer (Aug. 31, 2020)

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