US Financial Regulators Signal That They Will Use Their Supervisory Authority To Press Climate Agenda

11 / 03 / 21

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- **Financial regulators will use their supervisory authority to make sure banks weigh the risks of lending to, investing in and otherwise supporting carbon centric activities.**
- **The risk-based approach will force a reexamination of many assets and businesses.**
- **It is unlikely that regulators will impose rigid mandates.**

The Biden administration has made addressing climate change a top priority across the government, and U.S. financial regulators are now taking steps to translate that broad policy initiative into concrete policies and initiatives.

From their public pronouncements and actions, it is becoming increasingly clear that regulators will address climate change issues through their authority to supervise the safety and soundness of financial institutions and preserve the stability of the financial system. They are likely to retool the supervisory framework used to assess risks and risk management to create incentives for institutions to increase investments and activities in green businesses and industries and reduce their involvement in those that are carbon-centric.

From the regulators' standpoint, approaching the problem through the supervisory process, where there is great latitude for subjective judgment, is preferable, both legally and reputationally, to an approach that would have regulators mandate specific investments or activities for financial institutions to address climate change.

Under the Biden administration, financial regulators have repeatedly stressed the risks that climate change poses.

On May 20, 2021, President Biden issued Executive Order 14030 (E.O. 14030), "Climate-Related Financial Risk," which directed the secretary of the Treasury, in her role as chair of the Financial Stability Oversight Council (FSOC), to consider how to combat climate change, especially as it affects the financial sector. E.O. 14030 specifically cited the potential impact on the stability of the U.S. financial system.

In response to E.O. 14030, FSOC issued a report that included concrete recommendations to help member agencies assess the financial risks of climate change, enhance climate-related data and disclosures and build expertise to address climate change. In addition, a White House report issued pursuant to E.O. 14030 aimed to "usher in a new era where climate-related financial risks are thoroughly understood — where they are measured, disclosed, managed, and mitigated across the economy...."

That sentiment has been echoed by key financial regulators. Federal Reserve Gov. Lael Brainard said in a speech that "climate change might be expected to increase financial system vulnerabilities" and noted that regulators should "ensure that the financial system is resilient to climate-related risks and well positioned for the transition to a sustainable economy." Likewise, in Senate testimony, Michael Hsu, acting head of the Office of the Comptroller of the Currency (OCC), cited the safety and soundness implications of climate change for the banks the OCC supervises, noting that physical risks from climate change may affect financial assets and borrowers' creditworthiness.

Internal changes at the regulators also reflect the new orientation. The OCC recently announced the appointment of the agency's first climate change risk officer, and the Federal Reserve created a Financial Stability Climate Committee (FSCC) to assess and

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address climate-related risks to financial stability. Both agencies have also been working with regulators in other countries on these issues, including through the Network of Central Banks and Supervisors for Greening the Financial System and the Basel Committee, which helps set prudential and regulatory standards globally.

Using supervisory authority will give regulators flexibility and help them avoid challenges to their actions.

From their public pronouncements and actions, it is becoming increasingly clear that regulators will leverage their supervisory authority to address climate change issues. By focusing on risks to individual institutions and the financial system at large, regulators will be operating in an area where they have broad discretion to apply their judgment. Under such an approach, regulators would adjust the supervisory framework and expectations to capture the financial and stability risks of climate change, many of which were outlined in a March 2021 Federal Reserve paper. Those factors would lay the groundwork to require financial institutions to:

- Assess the financial risks associated with the negative consequences of climate change, such as deteriorating public health, labor productivity, agricultural yields or public infrastructure; rising mortality rates; and weather-related property destruction.
- Implement a risk management framework to mitigate the financial risks of climate change, including reassessing asset values, changing the cost or availability of credit or reconsidering the timing or reliability of cash flows.
- Guard against the financial stability impacts of climate change by focusing on the risks of rare climate tail events that can amplify credit, liquidity and counterparty risks and challenge financial risk management in ways that are hard to predict.

If an institution's comprehensive risk management program fails to address the financial and stability risks of climate change, regulators can: (i) make exam findings, (ii) cite matters-requiring-attention and/or violations, (iii) lower supervisory ratings, or (iv) require remedial actions. Such supervisory actions could limit an institution's activities and increase the cost of operations. Ultimately, failure could be the basis of an enforcement action.

In addition, by linking climate change to risk management and financial stability, financial regulators will have a rationale for changing risk-based capital and liquidity rules to increase the cost of activities linked to carbon-heavy businesses and industries.

This supervisory based approach is already being put into action. The acting head of the OCC has said that his agency is working on climate risk management guidance for large lenders in collaboration with other banking regulators to help the banks navigate the physical and transition risks climate change poses. Similarly, in a conference speech, Fed Gov. Brainard stated, "I anticipate it will be helpful to provide supervisory guidance for large banking institutions in their efforts to appropriately measure, monitor, and manage material climate-related risks, following the lead of a number of other countries."

We expect that, at the same time regulators use their supervisory powers, they will also likely offer positive incentives to induce financial institutions to engage in desired investments and activities. For example, we expect them to issue guidance about green investments and activities that will receive positive consideration under the public welfare investment regulation (*e.g.*, 12 C.F.R. § 24) and the Community Reinvestment Act (12 U.S.C. §§ 2901-2908). There are long-standing precedents, for instance, for regulatory incentives to support wind power, solar power and energy conservation. Likewise, regulators, as they have done before, may encourage tax-advantaged investments in green businesses and industries.

Conclusion

Given the emerging supervisory approach to climate change, financial institutions should not rush to engage in climate-related investments and activities without first instituting a sound risk management framework that takes into account the consequences of climate change. That may entail adjustments in an institution's risk culture and appetite to reflect its activities and investments related to climate change, and changes in risk systems to identify, measure, monitor, and control the risks related to climate change.

Other steps institutions should consider include updates and changes to policies, processes, personnel (*i.e.*, ensuring the appropriate expertise and level of staffing), management information systems and quality control and assurance systems. Just as important, institutions should evaluate the appropriateness of their governance structure for climate-related investments and activities, such as the assigned roles, responsibilities and processes for deciding the merits of specific climate-related investment or activity.