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FINANCIAL INSTITUTIONS, FINANCIAL INVESTORS AND THE BIDEN ADMINISTRATION'S POLICY PRIORITIES

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How might the Biden Administration's policies around climate change and social and racial justice be reflected in its financial regulatory policy proposals? In this briefing, Clifford Chance experts look at the interplay between climate priorities and financial regulation; corporate disclosure of climate risks; the rapid growth of retail and institutional demand for environmental, social and governance (ESG) investment strategies; and the renewed urgency of efforts to address the racial wealth gap in financial services.

Prudential regulation of climate risks in banking

Prudential regulators have divided climate risks into two broad categories; physical risks and transition risks.

- **Physical risks** include extreme weather events such as hurricanes, floods, heatwaves, wildfires, chronic problems resulting from gradually rising temperatures and sea levels, and changes in precipitation and indirect eco system effects on soil quality and water supplies.
- **Transition risks** are the risks of the shift to a low carbon economy and include legislation and regulatory changes, technological changes and changes in consumer and investor sentiment.

"Regulators and industry participants look at climate risks and banking from two different, but complementary perspectives; microprudential and macroprudential," says Jeff Berman, a Partner in the financial regulatory practice in Clifford Chance's New York office, who focuses on regulation in the banking and investment management sectors. A microprudential perspective considers climate risks at the level of individual financial institutions, focusing on a bank's safety and soundness in the face of both physical and transition risks arising from climate change. For example, physical risks such as floods or wildfires could threaten the value of the collateral securing portions of a bank's loan portfolio, or damage the bank's own branch network and data centres. Whilst transition risks, such as technological innovations in the production or storage of energy, could threaten the value of the bank's investments in markets that rely on obsolete technologies.

A microprudential perspective considers climate risk at the level of the financial system as a whole, focusing on system-wide financial stability and the so-called "transmission channels" in the economy through which the physical and transition risks of climate change give rise to financial shocks. "These financial shocks in turn expose the financial system's vulnerability to the abrupt repricing of assets and claims," Berman says.

The Federal Reserve began talking seriously about climate risks last year. The Fed's Supervision and Regulation Report discussed the climate risks from a microprudential perspective, and its Financial Stability Report did so from a macroprudential perspective. Early this year, the Fed announced two committees specifically focused on climate risks, the Supervision Climate Committee on the microprudential side, and the Financial Stability Climate Committee on the macroprudential side.

But, according to Berman, the potentially most important policy drivers are "extraprudential" and lie beyond safety-and-soundness and financial stability concerns. "Extraprudential policymaking sees climate risks in banking from the perspective of broader climate policy

goals, focusing on regulatory incentives – and, potentially, outright intervention – to promote the transition to a low-carbon economy," he says. An example would be a move to increase the risk-weighting of bank loans for capital adequacy purposes if the borrowers engage in activities that tend to accelerate climate change, even in the absence of any increase in microprudential or macroprudential risks. "Regulators will feel pressure to enact climate policy for its own sake," says Berman, "but whether they can or will do so remains to be seen."

Corporate disclosure of climate risks and securities laws

There is a lot of activity in the Biden Administration focusing on disclosures by issuers regarding the ESG issues in their businesses. "There's a lot of concern about the disclosures that are being made, the content of those disclosures, and whether the disclosures should be standardized in some way," says Celeste Koeleveld, a litigation and dispute resolution Partner at Clifford Chance in New York, who specializes in financial regulatory matters, enforcement, internal investigations and white collar crime. In March, the acting Chair of the Securities and Exchange Commission (SEC), Allison Lee, directed staff to evaluate the SEC's disclosure rules with an eye towards facilitating the disclosure of consistent, comparable and reliable information on climate change and she has requested public input by June. "There's currently a real concern that investors just don't know what they're looking at when it comes to considering what companies are saying about ESG, especially with regard to climate change risks," Koeleveld says.

The SEC has a list of about 150 questions for comment to help it assess its role in evaluating what can be quantified, what can be measured, and whether it should draw on existing frameworks. "It's not clear where it's going to land and some of the questions go beyond financial metrics and include societal and policy goals such as diversity and inclusion metrics. It's quite controversial. There are Republican members of the Commission who are firmly opposed to this kind of an expansion of disclosure of requirements," says Koeleveld.

It's also worth noting that the SEC has created a climate and ESG taskforce within its enforcement division. This task force is supposed to develop initiatives to proactively identify ESG-related misconduct using data analytics and data mining. Koeleveld adds that transition risks are fertile ground for possible disclosure requirements, "but if you are trying to look into a crystal ball as to where we're headed, there's a huge amount of controversy about how clear the crystal ball is." In 2019, Exxon was accused by the New York State Attorney General of making misleading statements in its public disclosures about what it had done to incorporate or assess a transitional checklist. In response to demands from shareholders, Exxon had put together a committee to examine these issues and, ultimately, the judge decided that Exxon's disclosures were made in good faith and were as accurate as Exxon could make them.

The role of the New York Department of Financial Services

The New York Department of Financial Services has played an unexpected role in laying the groundwork for the Biden Administration's climate agenda.

During the Trump Administration, the NYDFS filled a void in terms of regulation and enforcement in regards to climate change. The NYDFS appointed Nina Chen as Sustainability and Climate Initiatives Director – a climate change tsar – and then began to explore how best to regulate and supervise in the area of climate change and ESG and possibly how to enforce. "This is all work in progress of course and you can't really enforce until you've regulated for a while and put people on notice of what you are looking for, but Chen has examined what

Europe is doing and the NYDFS has joined the Network for Greening the Financial System (NGFS) and the Sustainable Insurance Forum so it has taken some leaps forward in the area of climate change," says Koeleveld.

NYDFS also issued circular letters last year, providing guidance to banks, financial institutions and insurance companies on assessing climate risk, transparency and how environmental and sustainable goals should be part of an organisation's management structure. "It's clear that eventually this will become part of an enforcement action and, as DFS sets standards, other agencies or regulatory bodies will follow suit," she says.

ESG disclosures by investment managers and fund managers

The demand for ESG strategies by investors and clients of investment advisers has grown enormously. "ESG is not just a niche interest for a bunch of urban elites. There is real demand for it – a demand that the investment management industry is struggling to satisfy," says Berman. "It outstrips the supply of ESG offerings with good reason and that's because ESG is a difficult thing to manage. Just as it requires difficult disclosure, it requires difficult analysis on the part of managers who are looking to devise ESG products that actually take account of all the ESG type metrics while providing financial performance."

In a survey of institutional investors and family officers carried out by Ernst & Young last year, 51% of investors invested in ESG products and 26% of those were required as an organisation to invest in ESG products. It varies by region – in North America only 15% were required by their charters to invest in ESG products compared with 42% of institutional investors in Europe. In addition, 60% of the investors surveyed said climate risk is one of the top ESG risks and opportunities influencing their decision making, whilst 44% said climate risk received the largest increase in their focus in 2020. "Given the huge demand for ESG-related investment vehicles, it is really no surprise that the SEC is looking carefully at the quality of disclosures by investment managers," says Berman. In April, the SEC issued a risk alert citing concerns about misleading disclosures by investment managers on their approach to ESG. "I think it sent ripples through the industry. It's a call to put best practices in place and to prepare for increased scrutiny by the SEC in this area. Currently, there isn't the right kind of compliance structure in place to monitor the alignment between what managers say and what they do. The quality of the services provided and the transparency involved is either going to make or break the industry's ESG growth strategy," says Berman.

He adds that ESG used to mean that "you invest in everything except for alcohol, tobacco, firearms and gambling. It was about being very clear on what you do and what you don't do. Then it moved onto some stock pickers following ESG strategies based on nothing more than the identity and public perception of the issuers whose stocks they were recommending. That is not an analytical approach, it's a virtue-signalling approach and that's the kind of thing that got us to where we are now."

Berman says that due to investor demand and the fees that investors should be willing to pay for the kind of penetrating analysis that ESG requires, it is, in some respects, the future of the asset management industry.

Racial equity

The racial wealth gap in the U.S. is going to be a key focus of regulatory reform under the Biden Administration. A Federal Reserve study from September 2020 indicates that the median and mean wealth of a Black family in the U.S. is less than 15% of the median and mean wealth of a white family due to long term factors, including a lack of home ownership opportunities and lack of relative access to tax-sheltered retirement accounts and saving plans. One distinct difference in savings patterns among Black and white families is that Black families are often forced to liquidate their most valuable

long-term assets in order to meet emergency needs, whereas a white family could dip into its liquid assets or savings or its checking account to meet those same needs. "There's no question that home ownership is the most important of all these factors in explaining the racial wealth gap. The long history of housing discrimination means that generations of Black families have missed out on the fantastic appreciation in home prices and that has reinforced and perpetuated this wealth inequality," says Berman.

As a result, one of the things the Biden Administration is going to focus on is the existing laws in favor of fair lending and fair housing; that prohibit discrimination in the extension of credit and in the choice of residence; and to go after these more energetically than previously.

Berman says that we are going to see is a resurgence in enforcement claims that are based on a disparate impact theory – not a theory that relies on evidence of actual intentional discrimination, but rather on patterns of outcomes that suggest that an apparently race-neutral standard might have a different impact on a minority family or individual than not.

"The other thing we're going to see a focus on, is the idea to replace the three main credit reporting firms, Equifax, Transunion and Experian, with a public credit reporting bureau over a period of some seven years. This is legislation that hasn't been introduced yet, but it's widely anticipated and we can question whether the government, would do a better job than the private sector and whether that would be any more transparent or any more accessible. So, while this is getting a lot of press coverage, I rather doubt in the long run that this is going to be something where the Administration is going to want to expend a whole lot of political capital, but we'll see," he says.

Koeleveld says that, given the narrow advantage Democrats hold in Congress, we are not likely to see many major legislative enactments. "It's such a disappointment to see how there is hardly any bipartisan legislation. It's so rare that you get something that is sensibly put together, with people coming together with their disparate ideas and then passing legislation that everybody can stand behind. The chance of really progressive legislation being enacted right now is not that great." She adds that we are likely to continue to see a lot being done by executive orders and by agency action. "Of course agency action is subject to review in the courts so a lot of what agencies do is constantly being wrangled with various actors trying to stop it with court action, with mixed results."

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