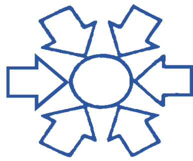

Financial Services Management

U.S. Financial Climate-Risk Policy

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Executive Order on Climate-Related Financial Risk

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Impact Assessment

- Climate-risk disclosures may soon be mandated for financial institutions subject to federal regulation and/or to all publicly-traded companies, but rules mandating risk-based capital related to this risk or other express regulatory or supervisory actions are not expressly mandated by the president and thus will come later, if at all.
- Even in the absence of express risk-mitigation regulatory/supervisory standards, federal banking agencies may issue guidance or other statements stipulating additional climate-risk related actions in areas such as corporate governance, risk management, and the non-discriminatory provision of lending and other financial services to enhance environmental justice.
- FHA, USDA, VA, and – less certain – GSE underwriting and related requirements will take climate risk into direct account instead of relying on indirect assessments of the risks posed by extreme weather. Significant changes in single-and multi-family construction, lending, and community-development standards would ensue.
- No divestiture or other climate-risk mitigation requirements are discussed for private financial companies, omitting one possible Administration effort that would have put lenders and asset managers under still more political pressure from both sides of this debate.

Overview

President Biden has issued an executive order (EO) setting in motion a series of administrative actions designed to reduce both climate risk in the financial sector and in any way financial companies make it worse. Mandatory action by HUD and other agencies is also required to redesign federal mortgage backstops. These could have significant impact, but the White House otherwise has limited

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authority over U.S. financial regulation because all of the key agencies responsible for it are independent and thus not subject to direct mandates via an EO. While the Treasury Department is subject to this EO, its requirements under it are to use the Financial Stability Oversight Council to coordinate climate-risk reduction and disclosure efforts, using this important forum to encourage agencies to do so quickly and in accordance with the president's injunctions. Where independent agencies are headed by officials appointed by President Biden and/or in agreement with this agenda, action is likely; where agencies (e.g., the Federal Reserve) are more hesitant, the nature of follow-up remains to be seen.

Impact

Consistent with other Biden Administration actions since the inauguration, this EO makes clear that U.S. policy now prioritizes climate-risk reduction, with the statement now detailing how important this is with specific regard to the financial sector. The President here says that financial-sector failure properly to address climate risk threatens U.S. competitiveness, markets, family life's savings, and the ability of financial institutions to serve their communities. Because of this, the EO stipulates the need for clear, consistent, and "useful" financial-sector climate disclosures, noting in particular the importance of using "behavioral insights" in crafting them and the need not only to capture physical and transition risk, but also their disparate impact.

These stipulations for acceptable financial-risk climate disclosures go well beyond the factors proposed for public disclosure in international standards.[1]

These global standards were already the basis for the work the banking agencies have undertaken to consider climate risk as well as for the SEC's work in this arena.[2] However, going farther as directed in this order could involve demands for complex or even subjective determinations financial companies may find challenging to satisfy and that pose additional legal and reputational risk.

The order also stipulates a change in federal mortgage-finance activities to reduce climate risk and encourage risk mitigation. HUD, the USDA, and VA are under executive-branch control and will thus begin to implement underwriting and other standards as directed in this executive order. This could take the form of penalty charges or loan-purchase/insurance restrictions related to exposures deemed problematic, incentives to encourage risk mitigation in certain communities, enforcement actions related to potential disparate impact due to private lending practices, and other actions with broad implications not only for financial institutions and investors, but also U.S. land-use and community-development policy.

As an independent agency, the Federal Housing Finance Agency is not bound by the order, although it has already taken some action with an eye to climate risk, issuing a request for information seeking input on a wide range of related matters without indicating any preferred policy action.[3] Although not expressly obligated by the EO, FHFA could nonetheless now advance its work to go farther in concert

[1] FedFin Issue Brief: Going Green: The Future of U.S. Climate Risk Financial Policy, October 26, 2020.
[2] See **GREEN6**, *Financial Services Management*, March 18, 2021.
[3] See **GSE-012121,** *GSE Activity Report*, January 21, 2021.

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with HUD under this director or his successor. Were this to occur, the impact of new climate-risk lending standards would be still more profound.

Although urging and in some cases mandating green policies, the EO addresses fossil-fuel and other controversial holdings only with respect to federal investment and pension plans. These are under orders to reduce their climate-risk exposures not only to avoid undue risk, but also to meet the Administration's climate-change objectives. Although the President's broad concerns about the financial sector may suggest asset-divestiture standards, there is no suggestion that banks or asset managers would be mandated or even directly encouraged to eschew investments in certain sectors deemed problematic to global warming. There is also no direct or indirect mention of sanctions designed to achieve these divestiture objectives such as the stress-testing for climate risk or penalty charges for "brown" exposures outlined by the Bank for International Settlements.[4] It is possible that agencies could report back to the President that they are interested in pursuing policies along these lines when the FSOC report (see below) is sent to the White House, but formal rulemaking would be required to implement any such recommendations.

Although the order steers clear of even mentioning express financial-sector lending or investment requirements, it addresses how retirement savings are calculated and the extent to which pension and other fiduciaries can purchase investments believed to advance environmental, social, and governance (ESG) objectives. Under the Trump Administration, the Labor Department took a strongly-negative stance against ESG investing, issuing a rule making it considerably more difficult for plan fiduciaries to hold such assets without complex showings of equivalent return.[5] The Biden Administration DOL has already put that rule on hold with clear plans to rescind it; with this directive, the agency is under orders to begin to do so no later than this September. With this green light, asset managers will feel more certain of their ability again to acquire assets with ESG characteristics, renewing market demand for assets already favored by some individual and institutional investors.

Finally, the report does not in any way seek to direct the Federal Reserve with regard to climate risk and its monetary policy or asset portfolio. Global central banks are increasingly using their portfolios to acquire assets deemed beneficial to the climate, but the FRB has shown no inclination to do so and, even if it wished to do so, has uncertain legal authority to invest in assets between direct and indirect obligation of the federal government.

What's Next

This order was issued on May 20. Some have called it more a "plan for plans" than an actual plan, a fact resulting from the White House's limited authority over independent agencies noted above. However, the EO does include a mandatory report from Treasury within 180 days sure to spur action by FSOC, at

[4] See *Client Report* **GREEN**, January 22, 2020.

[5] See **ESG2**, *Financial Services Management*, November 9, 2020.

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least some independent agencies, and – upon the report's filing – Congress, to the extent Democrats can persuade Republicans to join them expanding agency authority and/or requirements. However, Republicans to date have argued that climate risk is a matter outside the ambit of federal financial regulations.[6]

Analysis

After stating the overarching policy noted above, the executive order mandates that:

- Assistants to the President for both the economy and climate are to work with the Treasury Secretary and OMB Director to craft a comprehensive strategy within 180 days addressing measurement, assessment, reduction, and disclosure of climate financial risk with particular attention to workers and communities of color. In addition to other matters, this group is also to assess the financial needs associated with achieving net-zero greenhouse-gas emissions by no later than 2050.
- The Treasury Secretary is also to engage via the FSOC to assess climate change's financial-stability risk as well as that to the U.S. more generally, facilitating information sharing and reporting to the President within 180 days on how FSOC agencies are integrating climate risk into their broader work. The report is also to assess the need for mandatory disclosures and any impediments to incorporating climate risk into supervisory and regulatory activities.
- The Treasury Secretary is also to direct the Federal Insurance Office (FIO) to assess risk, supporting FSOC's deliberations and working with the states to identify potential for major disruptions to insurance services. OFR is to support this work as well as that of the FSOC more generally.
- The Secretary of Labor is to identify actions needed to protect life savings and pension benefits, considering (i.e., likely issuing) a proposal for public comment by September of 2021 to repeal the ESG rule noted above as well as the last Administration's proxy-voting rule. Labor is also to send the White House a report on this and other tasks required by the EO within 180 days.
- OMB and the White House, in consultation with Treasury, are also to identify ways to incorporate climate risk into federal lending programs, as well as to improve an array of other federal actions and programs following reports mandated for all federal agencies subject to executive-branch authority. HUD, Agriculture, and the VA are also expressly instructed to integrate climate financial risk into underwriting and other standards. Flood-insurance risk requirements are also reinstated.

[6] See *Client Report* **GREEN7**, March 18, 2021.

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